

**SB**

**151**

**SFIN**

**FILE**

**SENATE FINANCE COMMITTEE REPORT**  
**First Committee of Referral**

REPORTED OUT  
 APR 25 2005  
 SENATE FINANCE  
 COMMITTEE

DATE: 3/23/05

FURTHER:

Date of 5-Day Notice: \_\_\_\_\_  
 (in accordance with Uniform Rule 23)

DATE TURNED  
 IN TO OFFICE: 4/25/05

Finance Committee considered SENATE BILL NO. 151

**SB 151 NO TAX DEDUCTION FOR DOMESTIC OIL**

"An Act excepting from the Alaska Net Income Tax Act the federal deduction regarding income attributable to certain domestic production activities; and providing for an effective date."

and recommends:

- be replaced with \_\_\_\_\_ CS \_\_\_\_\_ (\_\_\_\_\_)
- adopt previous \_\_\_\_\_ CS \_\_\_\_\_ (\_\_\_\_\_)
- attached amendment(s)
- adopt Letter of Intent by \_\_\_\_\_ Committee
- further referral to \_\_\_\_\_ Committee

|                          |                          |
|--------------------------|--------------------------|
| <b>CS Senate Bill:</b>   |                          |
| <input type="checkbox"/> | Same Title               |
| <input type="checkbox"/> | New Title                |
| <b>SCS House Bill:</b>   |                          |
| <input type="checkbox"/> | Same Title               |
| <input type="checkbox"/> | Technical Title Change   |
| <input type="checkbox"/> | New Title w/ SCR # _____ |

**NEW FISCAL NOTE(S):**

| Department | Date    | Fiscal | Ind. | Zero | FN# |
|------------|---------|--------|------|------|-----|
| Rev.       | 4/19/05 |        | X    |      |     |
|            |         |        |      |      |     |
|            |         |        |      |      |     |
|            |         |        |      |      |     |
|            |         |        |      |      |     |

**PREVIOUS FISCAL NOTE(S):**

| Department | Date | Fiscal | Ind. | Zero | FN# |
|------------|------|--------|------|------|-----|
|            |      |        |      |      |     |
|            |      |        |      |      |     |
|            |      |        |      |      |     |
|            |      |        |      |      |     |
|            |      |        |      |      |     |

APPROPRIATION - no fiscal note

| SIGNATURES AND RECOMMENDATIONS: | DO PASS | DO NOT PASS | NO REC | AMEND |
|---------------------------------|---------|-------------|--------|-------|
| <i>[Signature]</i>              |         |             | ✓      |       |
| <i>[Signature]</i>              |         |             | ✓      |       |
| <i>[Signature]</i>              |         |             | ✓      |       |
| <i>[Signature]</i>              |         |             | ✓      |       |
| COCHAIR: <i>[Signature]</i>     | ✓       |             |        |       |
| COCHAIR: <i>[Signature]</i>     | ✓       |             |        |       |

APR 23 2005

SENATE FINANCE  
COMMITTEE

# FISCAL NOTE

STATE OF ALASKA  
2005 LEGISLATIVE SESSION

Fiscal Note Number: \_\_\_\_\_  
Bill Version: CSSB 151  
( ) Publish Date: \_\_\_\_\_

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Revenue 04  
Title Qualified Production Activity Income RDU Tax and Treasury  
Component Tax  
Sponsor Governor  
Requester Sen. Finance Component No. 2476

**Expenditures/Revenues (Thousands of Dollars)**

Note: Amounts do not include inflation unless otherwise noted below.

| OPERATING EXPENDITURES | FY 2006  | FY 2007  | FY 2008  | FY 2009  | FY 2010  | FY 2011  |
|------------------------|----------|----------|----------|----------|----------|----------|
| Personal Services      |          |          |          |          |          |          |
| Travel                 |          |          |          |          |          |          |
| Contractual            |          |          |          |          |          |          |
| Supplies               |          |          |          |          |          |          |
| Equipment              |          |          |          |          |          |          |
| Land & Structures      |          |          |          |          |          |          |
| Grants & Claims        |          |          |          |          |          |          |
| Miscellaneous          |          |          |          |          |          |          |
| <b>TOTAL OPERATING</b> | <b>*</b> | <b>*</b> | <b>*</b> | <b>*</b> | <b>*</b> | <b>*</b> |

|                             |  |  |  |  |  |  |
|-----------------------------|--|--|--|--|--|--|
| <b>CAPITAL EXPENDITURES</b> |  |  |  |  |  |  |
|-----------------------------|--|--|--|--|--|--|

|                               |                |                |                 |                 |                |                 |
|-------------------------------|----------------|----------------|-----------------|-----------------|----------------|-----------------|
| <b>CHANGE IN REVENUES ( )</b> | <b>8,230.0</b> | <b>9,420.0</b> | <b>10,635.0</b> | <b>10,590.0</b> | <b>9,995.0</b> | <b>14,955.0</b> |
|-------------------------------|----------------|----------------|-----------------|-----------------|----------------|-----------------|

**FUND SOURCE (Thousands of Dollars)**

|   |          |          |          |          |          |          |
|---|----------|----------|----------|----------|----------|----------|
| 1002 Federal Receipts                   |          |          |          |          |          |          |
| 1003 GF Match                           |          |          |          |          |          |          |
| 1004 GF                                 |          |          |          |          |          |          |
| 1005 GF/Program Receipts                |          |          |          |          |          |          |
| 1037 GF/Mental Health                   |          |          |          |          |          |          |
| Other (Specify Type--Do not abbreviate) |          |          |          |          |          |          |
| <b>TOTAL</b>                            | <b>*</b> | <b>*</b> | <b>*</b> | <b>*</b> | <b>*</b> | <b>*</b> |

Estimate of any current year (FY2005) cost: 0.0  
Check this box (X) if funding for this bill is included in the Governor's FY 2006 budget proposal:

**POSITIONS**

|           |  |  |  |  |  |  |
|-----------|--|--|--|--|--|--|
| Full-time |  |  |  |  |  |  |
| Part-time |  |  |  |  |  |  |
| Temporary |  |  |  |  |  |  |

**ANALYSIS:** (Attach a separate page if necessary)

\* See page 2

Prepared by: Chuck Harlamert Phone 465-2320  
Division: Tax Division Date/Time 4/19/05 2:12 PM  
Approved by: Tom Boutin, Deputy Commissioner Date 4/19/2005  
Agency: Revenue

## FISCAL NOTE

STATE OF ALASKA  
2005 LEGISLATIVE SESSION

BILL NO. CSSB 151

### ANALYSIS CONTINUATION

Included in the American Jobs Creation Act of 2004, codified as Internal Revenue Code Section 199 effective 1/1/2005, is a federal tax deduction for Qualified Production Activity Income (QPAI). Alaska's corporate income system is based on Federal law and we automatically adopt federal changes unless a legislative act directed otherwise. Thus, the QPAI is now an allowable deduction for Alaskan corporate income taxes. This bill decouples from the Internal Revenue Code with respect to section 199, and does not allow the QPAI deduction in computing the Alaska corporate net income tax.

The purpose of the federal QPAI deduction is to improve the competitiveness of US manufacturers in international markets. Broadly speaking the federal QPAI deduction is a partial exclusion of income earned from U.S. manufacturing activity. The deduction rate is 3% for 2005, increasing to 6% in 2007 and 9% for 2010 and thereafter. Affected industries with an Alaskan presence include oil and gas production, refining and marketing, construction, fishing and fish processing and mining.

At the federal level, the effect of the QPAI deduction is to tax profits from US production activity at a lower rate than profits earned from foreign production activity. This policy result cannot be replicated at the state level. In order to avoid impermissible discrimination against economic activity outside of the state, taxpayers will be allowed the QPAI deduction on their Alaska return for all production profits whether the activity occurred in Alaska, another state, or in a foreign country. Production activity conducted in-state, domestic out of state, or in a foreign country will be awarded an equal deduction. Alaska's QPAI deduction will reduce the amount of state corporate income taxes paid by targeted industries, but will not mirror federal tax policy to favor Alaska production activity over non-Alaskan production activities.

#### Cost Discussion

The bill will avoid future operating costs. The department can rely heavily on IRS audit and enforcement with respect to QPAI activities conducted in the US and reported on federal tax returns. However, the department must independently monitor QPAI deductions claimed for foreign production activities. This new challenge may be met with additional resources, redirected resources, both, or simply ignored. Ultimately the deduction will produce additional costs and/or revenue losses in addition to the revenue losses from the exclusion itself. The cost of administering the QPAI deduction will begin to present themselves in FY07. We estimate that the cost of administering the QPAI deduction could exceed \$500 thousand per fiscal year in FY09, but may decline as filing methodologies and audit techniques are refined and stabilize. This bill would avoid these costs or alternate consequences.

#### Revenue Discussion

The chart below reflects our estimate of revenue losses (\$ millions) resulting from the QPAI deduction against our forecast of corporate tax revenues taking into account the gradual phase in of the deduction.

|         | High     | Low     | High     | Low     |
|---------|----------|---------|----------|---------|
| FY 2005 | (5.40)   | (4.85)  | FY05-07  |         |
| FY 2006 | (8.65)   | (7.81)  | (23.92)  | (21.63) |
| FY 2007 | (9.87)   | (8.97)  |          |         |
|         |          |         | FY08-010 |         |
| FY 2008 | (11.16)  | (10.11) |          |         |
| FY 2009 | (11.10)  | (10.08) | (32.75)  | (29.69) |
| FY 2010 | (10.49)  | (9.50)  |          |         |
|         |          |         | FY11-13  |         |
| FY 2011 | (15.71)  | (14.20) |          |         |
| FY 2012 | (16.12)  | (14.56) | (48.17)  | (43.56) |
| FY 2013 | (16.34)  | (14.80) |          |         |
| FY05-13 | (104.84) | (94.88) |          |         |

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- Find out what constitutes manufacturing or production activities in the United States
- Acquire the latest strategies for allocating costs and maximizing qualified production activity income (QPAI)
- Understand the new definitions under Sec. 199 for determining domestic production gross receipts (DPGR) and domestic production property (DPP)
- Discover planning techniques to avoid the wage and income limitations on the amount of the DP deduction
- Find out how construction and related service companies can duplicate Sec. 199 benefits
- Learn how the DP deduction applies to pass-through entities, including S corporations, partnerships, co-operatives
- Update your knowledge of the latest IRS compliance requirements, including Notice 2005-14 and Forms



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4/5/05



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Learn how your company can generate U.S. tax savings in 2005 from domestic production activities!

## Monday, Day One

8:00 am Registration and Continental Breakfast

8:30 am Overview of the New Domestic Production Regime

- Understanding how the new DP tax regime operates - phase-in rules for 2005-2006 and 2007-2009
- Review of Sec. 199 and IRS Notice 2005-14 - new definitions for DPGR, MPGE, QPAI and EAG
- Optimizing U.S. tax benefits in 2005 using Sec. 199 and extraterritorial income exclusion benefits
- Scope of products and services included in DPGR

9:15 am Qualifying Domestic Production Property

- Determining what constitutes manufacturing or production activities in whole or significant part
- When manufacturing activities are substantial in nature
- Treatment of imported products or property subject to further manufacture outside the United States
- Treatment of component parts - application of MPGE safe harbor
- Special rules for computer software and qualified films, electricity, natural gas and potable water

10:30 am Refreshment Break

10:45 am Determination of Eligible Domestic Production Receipts

- Understanding the rules for Domestic Production Gross receipts (DPGR)
- Identifying amounts derived from qualified sales, leases or licenses - treatment of interest and late fees
- Goods produced inside and outside the United States - allocation of GR between items of DPGR and non-DPGR
- Treatment of computer software and advertising income

12:15 pm LUNCHEON

1:30 pm Techniques for Increasing Domestic Production Benefits

- Strategies for increasing the income and wage limitations - determining affiliated group domestic production income
- Computation of expanded affiliated group (EAG) deduction under Sec. 199 - special rules for consolidated groups
- Review of options in defining W-2 wages - unmodified and modified Box 1 method

2:30 pm Refreshment Break

2:45 pm Computing Qualified Production Activity (QPAI) Income

- Determining QPAI income (loss) on an item-by-item basis
- Determining cost of goods sold attributable to DPGR under Secs. 471 and 472
- Interrelationship with Sec. 263A and expense apportionment rules - exceptions for design and development costs
- Treatment of other deductions - losses, NOLs and research
- Calculating QPAI for computer software and qualified films or sound recordings

4:00 pm Special Industry Issues

- Minneapolis - Food/ Manufacturing
- New York - Film and TV Production/Real Estate

5:00 pm Meeting Adjourns for the Day

## Tuesday, Day Two

8:00 am Continental Breakfast

9:00 am Special Issues in Claiming Domestic Production Benefits

- Application of Sec. 199 to pass-through entities, including S corporations, partnerships, co-operatives
- Limitations on the amount of DP allowed in computing AMTI
- Effect of acquisitions and dispositions on determination of DPGR, W-2 limitation and Sec. 199 benefits
- Interrelationship with the FTC provisions - allocation of domestic production and expenses to foreign source or export income

10:30 am Refreshment Break

10:45 am Qualifying Services for

- Domestic Production Benefits
- Definition of qualified service activities, including repair, overhaul and maintenance activities conducted in the United States
- Determining QPAI for qualified design and development activities
- Generating QPAI from services that are embedded in a contract - situations where the embedded service rule may not apply
- Existing federal income tax principle - a trap for the unwary?

12:15 pm LUNCHEON

1:15 pm Procedural Aspects of Claiming DP Benefits

- Obtaining the data for QPAI computations - establishing a corporate tax reporting package
- Tax provision accounting - FASB Staff Position FAS 109-1
- Allocation of Sec. 199 deduction among EAG members based on QPAI
- Accounting for allocations of QPAI and W-2 wages to partners and S corporation shareholders

2:15 pm Refreshment Break

2:45 pm Compliance Aspects of Claiming DP Benefits

- Latest IRS guidance and filing requirements for U.S. taxpayers - claiming Sec. 199 deductions for estimated tax payments
- IRS and Secretary intend that DP deduction should be available to a wide variety of production activities

4:00 pm Meeting Ends

Time subject to change

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# Maximizing U.S. Tax Benefits on Domestic Production Activities

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## Why You Should Attend

Don't leave money on the table in 2005! The 2005 Jobs Act contains significant tax savings for U.S. manufacturing, production, agricultural and construction companies. The new Domestic Production (DP) deduction under Sec. 199 permits companies to deduct up to 3% of their qualified activities income in 2005 and 2006. By 2010, the deduction increases to 9%. In today's post-Sarbanes-Oxley environment, tax departments are responsible for developing internal controls to obtain the necessary data and provide full and adequate disclosure of their DP deduction.

The DP deduction will reduce the U.S. tax liability of qualified companies and increase cash flow from business operations. Today, all U.S. tax practitioners need to be aware of these new rules and how to assess benefits for their company or clients.

The new DP deduction is not elective, but applies to all U.S. taxpayers, including C and S corporations, partners in partnerships, members of co-operatives and LLCs, as well as individual businesses.

Tax practitioners have already received IRS guidance under Notice 2005-14, indicating what activities qualify and limitations on claiming the Sec. 199 deduction. In addition, the FASB has issued ISP-1, which discusses the proper tax accounting treatment for the DP deduction under Sec. 199.

CITE invites you to attend the First Annual Conference Series on "Maximizing U.S. Tax Benefits on Domestic Production Activities". This course has been designed to provide you with comprehensive coverage of the new provisions and what you need to do to comply with the IRS reporting requirements.

Learn whether your company or client qualifies for the DP deduction under Sec. 199 in 2005. Find out how to maximize your tax benefits and avoid limitations involving W-2 wages or net income.

## Who Should Attend

This new course - offered only by CITE - is designed for corporate tax accountants and attorneys, including Tax Directors and Managers, Tax Counsel and Controllers, and tax advisors responsible for preparing U.S. tax estimates or returns and financial statements. Attorneys, accountants and investment bankers in private practice also must become familiar with the new Sec. 199 rules for evaluating the effects of M&A activities or projecting net income from U.S. operations. No prerequisites are required.

## Hotel Accommodations:

CITE's block of discounted sleeping rooms is limited - reserve your sleeping room early! A limited block of rooms at a reduced rate has been set aside for CITE attendees at the following hotels:

Le Meridien - Minneapolis - June 13 & 14  
601 First Avenue North, Minneapolis, MN 55403  
Limited time reduced rate \$199.00 per night

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Limited time reduced rate \$175 single/double

Please contact the appropriate hotel and mention that you are attending the course listed under the Council for International Tax Education. The block will be released 30 days prior to the meeting, so make your reservation early. We cannot guarantee rates or availability. Your sleeping room is not included in the registration fee.

## Educational Course Credit:

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BY RICHARD R. SHAVELL

# The American Jobs Creation Act of 2004

## Significant Tax Cut Legislation

On October 22, 2004, President Bush signed his fifth significant piece of tax-cut legislation, the American Jobs Creation Act of 2004 (PL 108-357). There are several important provisions for the construction industry in the Act, including:

- A new special deduction originally intended to focus on the export and manufacturing industries, but which now includes construction activities;
- Increased and newly accelerated depreciation opportunities that provide incentives for increased construction services; and
- Several business provisions that impact contractors.

### The New Deduction

In exchange for repealing significant tax benefits for exporters, Congress is implementing a 9% (when fully phased-in) deduction for certain "qualified production activities." Available to corporate and most pass-through entities, the new deduction will be based on a complicated computation of "qualified production activities income" (QPAI).

"Domestic production gross receipts" is part of QPAI and includes: **1)** "construction performed in the United States or," **2)** "engineering or architectural services performed in the United States for construction projects in the United States." [PL 108-357 §199(e)(4)(A)(ii) and (iii)]

Note that "construction activities" are directly related to the erection or substantial renovation of residential or commercial buildings and infrastructure. Substantial renovations include structural improvements – but not cosmetic changes, such as painting. The calculation of this deduction has significant limitations and adjustments that determine which portion of these activities' gross receipts will be considered.

Generally, the new deduction is calculated by applying a phased-in percentage to the lesser of QPAI or taxable income. The rate to calculate the deduction is scheduled to phase-in as 7% for 2005-2006, 6% for 2007-2009, and 9% after 2009.

The implication is that, in many cases, contractors will benefit from the new deduction and be able to reduce taxable income. In exchange for this, contractors may be faced with ancillary concerns such as an increased compliance burden. (For interim guidance, see IRS Notice 2005-14.)

### New Depreciation Provisions

Once again, *depreciation is the GOP's golden carrot* to entice businesses to purchase certain assets and begin construction activities that might otherwise be delayed. This latest Act provides several new provisions, extends expensing thresholds, and also addresses several perceived abuses.

### 15-Year Recovery Period

A new 15-year recovery period will apply to certain leasehold improvements placed in service after October 22, 2004 and before 2006. This is a significant reduction from the 39-year period that would otherwise apply. The new rules cover interior improvements to nonresidential property provided:

- The improvement is made under a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee);
- The improvement is placed in service more than three years after the date the building was first placed in service; and
- The improvement is not attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

Generally, if a lessor makes a qualified leasehold improvement, a subsequent owner cannot claim it as qualified leasehold improvement property. Fifteen year straight-line depreciation will be used instead of the 15-year MACRS (150% declining balance) method. The bonus depreciation regulations will apply to defined qualified leasehold improvements.

### Qualified Restaurant Property

The restaurant industry secured a 15 year recovery period for "qualified restaurant property," placed in service after

October 22, 2004 and before 2006. For contractors specializing in restaurants, this provision may boost business.

Qualified restaurant property is defined as any improvement to a building:

- If the improvement is placed in service more than three years after the building was first placed in service; and
- More than 50% of the building's square footage is devoted to the preparation of, and seating for, on-premise consumption of prepared meals.

Property/restaurant owners who take advantage of this recovery period must use the straight-line depreciation method.

### Racetrack Improvements

Not to be outdone by the restaurant industry, a new provision assigns a MACRS recovery period of seven years to motorsport racetrack complexes (which include land improvements and support facilities, but not transportation equipment, warehouses, administrative buildings, hotels, or motels). The provision is effective for property placed in service after October 22, 2004 and before 2008.

### Section 179

The §179 expensing threshold of \$100,000 (adjusted for inflation) was scheduled to revert to \$25,000 in 2005, but is now extended through 2007.

However, only \$25,000 of the cost of a heavy SUV may be expensed under §179, effective for vehicles placed in service after October 22, 2004. Heavy SUVs – those with a gross vehicle weight rating (GVWR) of more than 6,000 pounds – are generally not subject to the "luxury auto" depreciation dollar caps and lease income inclusion amount rules.

Under the rules that applied before the Act, the entire cost of a heavy SUV used 100% for business could be expensed. Now, Congress has limited the deduction to \$25,000.

### Other Provisions

The Act has several provisions for businesses that should benefit contractors. For example, S corporations can now have up to 100 members, and all family members can elect to be treated as one member for the 100-member threshold. Other items of note include vehicle provisions and a general sales tax deduction.

### Vehicle Provisions

Heavy & Highway contractors may wish to scrutinize a provision exempting mobile machinery from federal highway taxes.

These changes should mean that mobile cranes, concrete pumpers, and certain paving equipment will not be taxable.

The new law codifies the current three-part design test effective for machinery that is: **1)** permanently attached to a chassis, **2)** designed to operate off-highway, and **3)** reaches jobsites over public roads under its own power.

The Act retains the full exemption from the 12% federal excise tax on new vehicles and the heavy vehicle use tax for equipment that meets the three-part test. The fuel tax will still apply, but a refund can be obtained at year-end if the equipment travels less than 7,500 miles on public roads during the year. Tires designed exclusively for off-road equipment will be exempt from the federal tire tax.

### General Sales Tax Deduction

Effective for 2004 and 2005, taxpayers may elect to take an itemized deduction for state and local general sales tax in lieu of the present-law deduction for state and local income taxes.

Taxpayers can either accumulate receipts or reference a table (see [www.irs.gov/pub/irs-pdf/p600.pdf](http://www.irs.gov/pub/irs-pdf/p600.pdf)) to determine their sales tax paid. In addition to the table amount, they can also deduct eligible sales taxes paid for vehicles, boats, and certain specified items. This is an added benefit for residents of the 10 or so states that have no income taxes. Taxpayers in other states must decide if they want to deduct the income or sales tax paid during the year.

### Conclusion

The American Jobs Creation Act of 2004 is a very broad and complex piece of legislation, with intricacies beyond this brief overview. To benefit from the Act, contractors need to contact a tax advisor to determine how the new law will affect their business. **BP**

RICHARD R. SHAWTEL, CPA, CCFP is President of Shawtel & Company, P.A., CPAs and Consultants, in Boca Raton, FL.

Rich has presented comments before the IRS on proposed regulations and has testified before the House and Senate on the business impact of proposed legislation.

A member of CFMA's South Florida Chapter, he is a member of the Tax and Tax-Exempt Affairs Committee, a member of the IMA's Council of Certified Construction Financial Planners (C3FP), as well as a member and former Chairman of the National Tax Committee of the ABC.

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53151

**taxanalysts** **special report**

**PRODUCING RESULTS: AN ANALYSIS OF THE NEW PRODUCTION ACTIVITIES DEDUCTION**

By Deloitte Tax LLP

Gary Hecimovich, partner; Michael Danilack, Thomas Mahoney, and Jan Skelton, principals; and Mark Garay, director, all of the Washington National Tax office of Deloitte Tax LLP, are the primary authors of this report.

The American Jobs Creation Act of 2004 (P.L. 108-357) established new IRC section 199, which permits taxpayers to claim a deduction from taxable income attributable to domestic production activities.

This special report provides an overview of section 199, which is effective for tax years beginning after December 31, 2004, and recent Treasury guidance on the same issue. It provides observations that: (1) put in context the meaning of many of the new law's complex and often novel tax concepts; (2) identify common issues and opportunities that business taxpayers may encounter; and (3) suggest actions taxpayers should take to improve their ability to take full and appropriate advantage of the new deduction.

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**I. Introduction**

On October 22, 2004, President George W. Bush signed the American Jobs Creation Act of 2004 (P.L. 108-357), legislation to phase out the extraterritorial income (ETI) regime. The centerpiece of the statute is new Internal Revenue Code section 199, which permits taxpayers to claim a deduction from taxable income attributable to domestic production activities.

When some members of the House Ways and Means Committee first began discussing how best to structure legislation to repeal the ETI regime, an early thought was to include some incentive to foster job creation with a particular emphasis on manufacturers, the primary beneficiaries of the ETI exclusion. As is clear from the statutory language of section 199, the new law provides benefits to a much larger group of businesses than those

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traditionally considered "manufacturers," and it is not limited to those taxpayers who previously benefited from the ETI regime.

Because the provision is effective for tax years beginning after December 31, 2004, taxpayers need to act immediately to assess the extent to which they can benefit from the new provision.

**A. The Not-So-Basic Calculation.**

When tax directors, chief financial officers, and other executives delve into the new deduction, they will quickly see the value in a provision in which taxpayers paying tax at the 35 percent marginal rate can potentially drop their marginal tax rate by 1 percentage point in year one, and eventually by more than 3 percentage points by 2010.

For 2005 new section 199 provides for a 3 percent deduction equal to the lesser of a taxpayer's qualified production activities income (QPAI) or taxable income, for the tax year. The allowable deduction increases to 6 percent for tax years beginning in 2007, 2008, and 2009, and finally grows to 9 percent for tax years beginning in 2010 and thereafter.

The deduction is limited to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in the tax year.

Taxpayers who want to claim a deduction under section 199 must document and determine items under the following formula:

Allowable deduction in 2005 = 3 percent multiplied by the lesser of:

- QPAI or
- taxable income

Limited to 50 percent of W-2 wages.

Although that may sound straightforward, the statute provides many new definitions and special rules that must be taken into account in computing the deceptively simple formula. Notice 2005-14, 2005-7 IRB 1, *Doc 2005-1241, 2005 TNT 13-7*, released by Treasury on January 19, 2005, provides a fairly comprehensive set of definitions and rules that will be the framework for forthcoming proposed regulations on the new deduction. But this recent Treasury guidance only scratches the surface in addressing issues that taxpayers will face.

This report is intended to provide an overview of section 199 and the recently released Treasury guidance. When appropriate we have provided observations that:

- put in context the meaning of many of the new law's complex and often novel tax concepts;
- identify common issues and opportunities that business taxpayers may encounter; and
- suggest actions taxpayers should take *now* to improve their ability to take full and appropriate advantage of the new deduction.

**Frequently Used Acronyms**

The statute and the notice include several technical terms that sometimes appear as acronyms in this report. We have listed them here for convenient reference:

- CGS — cost of goods sold
- DPGR — domestic production gross receipts
- EAG — expanded affiliated group
- NAICS — North American Industry Classification System
- QPAI — qualified production activities income
- QPAD — qualified production activities deduction
- QPP — qualifying production property

**II. Highlights of the Treasury Guidance**

At 102 pages, Notice 2005-14 is more extensive than many practitioners had anticipated and covers a wide range of the issues that have been a source of questions or concerns for taxpayers. Among the questions the notice addresses are the following:

- What activities qualify for the qualified production activities deduction?
- How does a taxpayer determine "domestic production gross receipts"?
- What does "manufactured, produced, grown, or extracted" mean?
- How will net operating loss carryforwards and carrybacks affect the QPAD?
- How are "contract manufacturing" situations treated?
- What "construction" activities qualify for the deduction?
- How should taxpayers treat transactions with "embedded services"?
- What do "W-2 wages" mean for purposes of the new law?
- What does manufactured "in significant part" in the United States mean?

(Noteworthy provisions covered by the notice are summarized on pp. 963 and 964.)

**III. Activities Qualifying for the Deduction**

Section 199 defines "qualified production activities income" as the excess of "domestic production gross receipts" over the sum of: (1) the cost of goods sold allocable to those receipts; (2) other deductions, expenses, or losses directly allocable to those receipts; and (3) a ratable portion of deductions, expenses, and losses not directly allocable to those receipts or to another class of income.

The statute provides no direction regarding whether a single taxpayer must treat all of its qualifying activities together for calculation purposes or whether, on the other hand, a taxpayer can separate its qualifying activities into individual separate business lines or individual product lines.

### Noteworthy Provisions

The notice covers many issues, but several merit particular emphasis. We believe the following are particularly noteworthy.

**No 'grouping' permitted.** According to the notice, QPAI is to be determined on an item-by-item basis *and is the sum of QPAI derived by the taxpayer from each item*. Thus, QPAI is not determined on a division-by-division, product line-by-product line, or transaction-by-transaction basis. QPAI calculated for each item may be positive or negative, *but those amounts are then netted together to arrive at a single QPAI amount for the taxpayer*. This approach eliminates any possibility of "grouping" transactions to isolate losses to maximize the QPAD.

**Separating 'the wheat from the chaff.'** The notice requires a taxpayer to separate its qualifying gross receipts from its nonqualifying gross receipts using a "reasonable method" that is "satisfactory" to the IRS and that "accurately identifies" its qualifying gross receipts. For the first time, many taxpayers will have to deal with the fact that different types of ordinary business income will receive very different tax treatment. In many cases, taxpayers will want to adopt new approaches to entering into their contractual arrangements and new ways to account for the profits associated with their transactions.

**Consistency with section 263A.** The notice generally provides that a taxpayer that manufactures, produces, grows, or extracts qualifying production property for purposes of the QPAD should also treat itself as a "producer" under section 263A. It is understandable that Treasury would seek to establish parity between the two methods, but the parity provided in the notice is a one-way street. The notice does not provide that any taxpayer treated as the producer for section 263A purposes will also be eligible for the QPAD. That could result in disparate treatment in several situations.

**Contract manufacturing.** The notice provides that if one taxpayer performs manufacturing activities for another taxpayer, only the taxpayer with the "benefits and burdens of ownership" of the manufactured property during the manufacturing process will be treated as the manufacturer. This tax ownership rule applies even if the taxpayer exercises direct supervision and control over the activities of the contract manufacturer or is treated as a producer of the property under section 263A. The notice states that this standard is based on principles under section 936 and section 263A. It is interesting, however, that the IRS has in other contexts taken the position that there can be multiple tax owners of produced property for the purposes of section 263A. But the notice clearly states that for purposes of section 199, there can be only one tax owner at any particular time.

Arguably, this rule draws an artificial and unnecessary distinction that could create big winners and big losers. The rule likely will force many companies to consider realigning their contractual relationships and will put much pressure on negotiating these types of contracts with third parties.

**Manufacturing in the United States.** The notice provides that property will be treated as manufactured by the taxpayer "in significant part within the United States" if the taxpayer can either satisfy a broad substantial-in-nature test or meet an objective cost safe harbor test. The notice provides that two categories of activities or costs — (1) packaging, repackaging, labeling, and minor assembly, and (2) design, development, or creation (or licensing) of intangible property — generally are not taken into account in applying either the substantial-in-nature test or the cost safe harbor test. The exclusion of those activities or costs is likely to be controversial, given that they are the basis for millions of U.S. jobs and have traditionally been regarded as part and parcel of many U.S. manufacturing operations. Moreover, there is a lack of parity with section 263A in that regard, because some packaging and assembly has been held to be production for purposes of section 263A.

**Bifurcating tangible mediums from qualified film, sound recordings, and computer software.** The notice requires a bifurcation of films, recordings, and software from the tangible medium in which they are embodied. That will require complex allocations. Moreover, how Treasury intends for this rule to apply is not entirely clear from the notice. Under one interpretation advanced by a government official in informal conversations, the bifurcation rule may reduce the section 199 benefit of companies manufacturing mass-produced copies of films, recordings, and software, when the underlying intangible was produced by another company.

**Important questions of character.** The notice provides that, for a transaction in which a service is provided along with the lease, rental, license, sale, exchange, or other disposition of property, only receipts attributable to the property transaction, and not receipts attributable to the "embedded" service, qualify for the QPAD. As a result, many taxpayers for the first time will be required to allocate gross receipts between the qualifying components of their transaction and the nonqualifying components. That will necessitate a new valuation analysis that has not been conducted before. Presumably, the IRS will be prepared to disallow the QPAD whenever it is arguably attributable to profit on a more-than-de minimis service.

**Dealing with deductions.** The notice provides three methods for allocating expenses (other than costs of goods sold) to offset qualifying domestic production gross receipts. The vast majority of taxpayers (those with average annual gross receipts, over the three prior years, of \$25 million or less) will be able to use one of two fairly simple methods. All other taxpayers, however, will be required to follow a modified form of the existing rules under section 861, which in the past applied only to taxpayers engaged in international business activities. This required use of the section 861 expense allocation rules will bring new levels of complexity for those taxpayers not previously accustomed to using those rules.

(Box continued on next page.)

Real property produced under a contract. In contrast to the rules related to tangible property, the notice permits multiple parties to claim the section 199 benefit relating to construction activities. Specifically, general contractors and subcontractors may both be able to claim a QPAD. Whether the land developer or owner will be able to claim a QPAD will likely turn on whether they are regarded as being in the trade or business of construction.

NAICS classification critical to the QPAD for construction activities. The notice provides that only construction activity by a taxpayer in a trade or business considered to be construction for purposes of the North American Industry Classification System is eligible for the QPAD for construction activities.

Methods for determining W-2 wages. The amount of a taxpayer's W-2 wages that must be determined for purposes of applying the allowable deduction limitation under section 199 will not be readily determinable by a taxpayer (that is, the amount is not separately reported for either payroll or income tax purposes). Therefore, the notice provides three alternative methods (including two simplified methods) for making the required calculations. Also, the notice makes clear that W-2 wages reported by another taxpayer under specified contract employment or paymaster arrangements may also be included in the W-2 wages of the taxpayer.

Application to passthrough entities. The notice confirms that the QPAD is determined at the partner or similar owner level. Each owner is allocated its share of passthrough entity items, and those items are aggregated with the partner's items from other qualified production activities to determine its deduction. The notice also clarifies that section 199 is applicable only to tax years of passthrough entities that begin on or after January 1, 2005.

Application to expanded affiliated groups. Section 199 treats all members of an EAG as a single corporation. The EAG computes a single QPAD, and that deduction must be allocated to group members. The notice provides rules (including a special rule for consolidated groups within EAGs) for computing taxable income and QPAI of EAGs, and allocating the deduction to EAG members. The notice confirms that most transactions between EAG members will be recognized, but also includes an anti-abuse rule to discourage transactions that have a principal purpose of qualifying for or modifying the amount of the QPAD for one or more members. A helpful attribution-of-activities rule essentially treats all EAG group members as a single corporation in determining whether a member is engaged in qualified production activities.

Getting your hands on the right information. Understanding how the new law works mechanically and what activities qualify for the new deduction is critical. But it is equally important for taxpayers to quickly determine how to capture the necessary information and documentation that will have to be analyzed to determine which of their activities will qualify for the deduction.

The notice, however, addresses this issue by providing that for purposes of section 199, QPAI is determined on an item-by-item basis and is the sum of QPAI derived by the taxpayer from each item. It makes clear that QPAI is not determined on a division-by-division, product line-by-product line, or transaction-by-transaction basis. QPAI calculated for each item may be positive or negative, but those amounts are then netted together to arrive at a single QPAI amount for the taxpayer.

#### Observations

If Treasury had chosen to permit grouping of related activities by business line, for example, a taxpayer suffering overall losses in one qualifying business line would have been able to nevertheless take advantage of section 199 for a profitable business line. The approach taken in the notice, however, eliminates any possibility for such helpful calculations. That approach is different from that previously taken regarding the calculation of benefits under the foreign sales corporation or FII regimes, where the government's transactional grouping rules provided benefits for profitable transactions or operations, despite losses realized elsewhere.

#### IV. Identifying DPGR

The statute identifies five specific categories of DPGR that will qualify for the QPAD. DPGR must result from certain transactions involving: (1) qualifying production property, (2) qualified film, (3) electricity, natural gas, or potable water, (4) construction, and (5) engineering and

architectural services. Each of those categories of DPGR is further defined through a variety of rules summarized below.

The notice requires a taxpayer to determine the portion of its gross receipts that are DPGR and the portion of its gross receipts that are not DPGR. When a taxpayer engages in transactions giving rise to both DPGR and non-DPGR, the notice requires the taxpayer to allocate its gross receipts from its transactions based on a "reasonable method" that is "satisfactory" to the IRS and that "accurately identifies the gross receipts that constitute DPGR." The notice sets forth the following factors to be taken into account in determining whether the taxpayer's allocation method is reasonable:

- whether the taxpayer uses the most accurate information available;
- the relationship between the gross receipts and the apportionment base chosen;
- the accuracy of the method chosen as compared with other possible methods;
- whether the method is used by the taxpayer for internal management or other business purposes;
- whether the method is used for other federal, state, or foreign income tax purposes;
- the time, burden, and cost of using various methods; and
- whether or not the taxpayer applies the method consistently from year to year.

The notice provides a de minimis safe harbor applicable when small amounts of non-DPGR are present. Under this de minimis rule, if the taxpayer's non-DPGR

is less than 5 percent of its total gross receipts, the taxpayer may treat all gross receipts as DPGR. That 5 percent de minimis approach is used in several other places in the notice where Treasury addresses specific situations in which it is necessary to allocate gross receipts to both qualifying and nonqualifying aspects of a single business activity or transaction.

**Advance payment rule.** The notice provides a special rule applicable when a taxpayer has gross receipts in the form of advance payments received in a tax year earlier than when the related qualifying activities are actually conducted. The rule requires that the taxpayer accurately identify, based on a reasonable method that is satisfactory to the IRS, whether the receipts (and corresponding expenses) qualify as DPGR.

#### Observations

For the first time, many taxpayers will have to deal with the fact that different types of ordinary business income will receive very different treatment for tax purposes. In many cases, taxpayers will want to adopt new approaches to entering into their contractual arrangements and new ways to account for many of their transactions.

For example, some taxpayers may want to begin separately negotiating for consideration for qualifying transactions that in the past have been included in a lump sum consideration received for both qualifying and nonqualifying activities. Also, many taxpayers with both qualifying and nonqualifying business activities will want to ensure that they are properly determining and accounting for the respective market-rate profit for each activity.

Neither the statute nor the notice contains a restriction on the time period during which the production activities must occur to give rise to DPGR. Consequently, qualifying property produced before the effective date of section 199 can give rise to DPGR. For example, DPGR can include receipts from the sale of spirits produced a dozen years before the enactment of section 199 (assuming all other requirements are satisfied here), but sold in a post-effective-date year.

The need to identify revenue streams based on the location of production activity will place a premium on having a thorough understanding of a taxpayer's information systems and tracking capabilities. To the extent they have not already done so, most taxpayers will want to begin conversations with their information technology and accounting departments to understand exactly what information exists within their organization and to determine the most efficient method to collect and analyze this information for purposes of the section 199 calculation.

#### A. 'Gross Receipts'

The notice defines the term "gross receipts" generally as "the taxpayer's receipts for the tax year that are recognized under the taxpayer's method of accounting used in that tax year for federal income tax purposes." The notice provides a series of examples of items that qualify as gross receipts under that definition. Those include total sales (net of returns and allowances), all amounts received from services, and any income from investments such as interest, dividends, rents, royalties, and annuities, regardless of whether the amounts are

derived in the ordinary course of the taxpayer's business. The notice also provides examples of items that do not qualify as gross receipts. Those include repayment of a loan, amounts derived from nonrecognition transactions (such as a section 1031 exchange), and sales or similar taxes, when the tax is imposed on the customer under the applicable state or local law.

#### Observations

With the guidance, Treasury has clarified that tax accounting concepts will determine gross receipts for section 199 purposes.

#### B. 'Manufactured, Produced, Grown, or Extracted'

Under the statute, for gross receipts from transactions involving "qualifying production property" to qualify as DPGR, the QPP must be "manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States." (Emphasis added.)

The notice states that the terms "manufactured, produced, grown, or extracted" include activities relating to manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; and cultivating soil, raising livestock, fishing, and mining minerals. The terms also include storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural products, provided the products are consumed in connection with, or incorporated into, the manufacturing, producing, growing, or extracting of QPP whether or not by the taxpayer.

#### Observations

Taxpayers will want to ensure that they appropriately consider all of their activities within the broad coverage provided by the term "manufactured, produced, grown, or extracted."

**1. Consistency with uniform capitalization rules.** The notice also provides that a taxpayer that has manufactured, produced, grown, or extracted QPP for the tax year should treat itself as a producer under section 263A regarding the QPP for the tax year unless the taxpayer is not subject to section 263A under the Internal Revenue Code, regulations, or other published guidance. The notice provides that a taxpayer that currently is not properly accounting for its production activities under section 263A may change its accounting method to comply with the producer requirements of section 263A.

#### Observations

It is beneficial to be treated as a producer to take advantage of the QPAD; however, it is not beneficial to be treated as a producer for purposes of the cost capitalization rules of section 263A. It is understandable that Treasury would seek to establish parity between the two methods. However, the parity provided in the notice is a one-way street. A taxpayer that reaps the benefit of the QPAD by virtue of being treated as a producer must also bear the burdens of treatment as a producer for purposes of the section 263A cost capitalization regime. The notice

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does not provide for the converse, which will result in disparate treatment in at least four areas:

- The IRS National Office has determined that there can be two tax owners for purposes of section 263A. Under section 199, there can be only one tax owner at a particular time.
- Section 263A treats a customer that is not the tax owner of property produced for that customer under a contract as a producer. Under section 199, this customer would not be treated as a producer.
- Taxpayers engaged in packaging and fairly minor assembly operations have been regarded as producers for purposes of section 263A. Those taxpayers may not be regarded as producers under section 199.
- Sections 263A and 199 both attempt to exclude certain de minimis activities from being regarded as production. However, section 263A employs a 10 percent test, while section 199 provides for a 20 percent safe harbor.

The application of the section 199 rules and their differences with section 263A are explored in greater detail below. In some instances, the inconsistency with section 263A may be appropriate in light of the different objectives of sections 263A and 199. In other instances, it might be appropriate for Treasury and the IRS to attempt to "close the gap" between section 263A and 199 by modifying either the ruling positions under section 263A, the proposed rules under section 199, or both. In any case, it is important to appreciate the one-way nature of the "consistency with section 263A" rule.

### C. 'By the Taxpayer'

Under the statute, taxpayers wishing to claim the QPAD for QPP must establish that the QPP was manufactured, produced, grown, or extracted "by the taxpayer in whole or in significant part within the United States." (Emphasis added.) Congress has made it clear that a taxpayer should not be able to benefit from the deduction unless the taxpayer itself is engaged in the manufacture, production, growth, or extraction of the underlying QPP.

The notice provides that if one taxpayer performs manufacturing activities for another taxpayer, only the taxpayer with the benefits and burdens of ownership of the tangible personal property during the manufacturing process will be treated as the manufacturer. For a taxpayer entering into a contract manufacturing arrangement with a third party, the availability of the QPAD will depend heavily on whether the arrangement is structured as a buy-sell arrangement or as a consignment arrangement from a tax perspective. That is, whether or not one of the parties to the transaction will be entitled to the QPAD for its own manufacturing activities will depend on whether it will bear the economic risk of loss on the raw materials and work-in-process while the goods are being processed by the third party. That rule applies even if the taxpayer exercises direct supervision and control over the activities of the contractor or is treated as a producer of the property under section 263A(g)(2).

For example, if the taxpayer allows the third party to bear the economic risk of loss on the raw materials and work-in-process, the third party would be eligible for the

deduction for its profits on its production activities. On the other hand, if the taxpayer itself bears the economic risk of loss on the raw materials and work-in-process (in a consignment, or toll, manufacturing arrangement), the taxpayer would be eligible for the deduction and the third party would not, regardless of the fact that the third party owns a factory in the United States and incurs substantial labor costs in manufacturing the product in that factory. The distinction between these two scenarios depends entirely on the fairly minor matter of which party bears the economic risk of loss on the raw materials and work-in-process, which essentially boils down to which party is funding the carrying costs and insurance costs associated with the inventory.

It is important to note that the notice makes that "by the taxpayer" or "contract manufacturing" rule applicable not only to qualifying transactions involving QPP but also to transactions involving (1) qualified film produced "by the taxpayer"; and (2) electricity, natural gas, or potable water produced "by the taxpayer" in the United States.

### Observations

Treasury apparently believes that drawing a distinction between contracting arrangements based on the tax ownership of the underlying property is important to ensure that two parties do not get the QPAD for the same activity performed on the same property. Treasury has overlooked two very important considerations, however. First, when a taxpayer pays a third party fair value for processing goods on its behalf (in a consignment manufacturing arrangement), it will deduct, as CGS or otherwise, the full fee (including the third party's markup for its work) in arriving at its taxable income. Thus, the taxpayer could never obtain the QPAD for the manufacturing profit associated with the third party's production activity. Moreover, as a result of the rule set forth in the notice, no party will be entitled to the QPAD for that manufacturing profit.

Second, when the taxpayer allows the third party to have tax ownership over the raw materials and work-in-process, the third party will be entitled to the QPAD on its own profits, but the taxpayer may earn significant additional profits attributable to its own manufacturing, production, growth, or extraction activities carried out either before the goods were transferred to the third party or after the goods were acquired (or reacquired) from the third party. At best, the notice leaves open the question of whether the taxpayer would also be eligible for the QPAD to the extent the taxpayer independently engages in qualifying activities regarding the QPP. At worst, the single beneficiary rule of the notice suggests that those qualifying activities would not give rise to a QPAD for the taxpayer simply because contract manufacturing was undertaken as part of the process.

Inconsistency with section 263A. The notice states that the tax ownership standard is based on the principles of sections 936 and 263A. The regulations under section 263A, however, regard one as a producer if the taxpayer is a tax owner of the property being produced. Treasury has interpreted the regulations to provide that more than one party can be an owner of property at the same time. Consequently, under section 263A, when one taxpayer performs production activities under a contract

with another taxpayer, both taxpayers may be regarded as tax owners of the property being produced; thus, both must capitalize costs under section 263A. However, only one of those taxpayers will be entitled to a QPAD.

Moreover, under section 263A, if a taxpayer has property produced for it under a contract (the customer), the taxpayer is treated as the producer of the property, even if it is not a tax owner of the property during the production period. Consequently, a customer that is not the tax owner of the property being produced will be required to capitalize costs under section 263A, but will be ineligible for a QPAD.

#### D. 'In Whole or in Significant Part'

Under the statute, taxpayers wishing to claim a deduction for QPP must establish that such property was manufactured, produced, grown, or extracted by the taxpayer "in whole or significant part within the United States." (Emphasis added.)

The notice provides that property will be treated as manufactured by the taxpayer in significant part within the United States if the taxpayer can either satisfy a broad substantial in nature test or meet an objective cost safe harbor test. The notice explains that those two tests were adopted from the test set forth in the section 954 regulations for establishing that a controlled foreign corporation is the manufacturer of property when the activity involves the assembly of component parts. However, the notice makes clear that the in-significant-part test does not incorporate the full substantial transformation analysis of the section 954 regulations. That is, the substantial-in-nature requirement of the QPAD is not the same as the requirements underlying the "not the property which it purchased" standard in the section 954 regulations.

**1. Substantial in nature.** Under the first test, the significant part requirement would be met if, based on all of the taxpayer's facts and circumstances, the manufacturing, production, growth, or extraction activity performed by the taxpayer in the United States is *substantial in nature*. For example, if property is manufactured, produced, grown, or extracted by the taxpayer outside of the United States (or by an unrelated party within 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 manufactured, produced, grown, or extracted 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. The notice indicates that if a taxpayer manufactures QPP in significant part in the United States and exports the goods for further manufacture outside the United States, the taxpayer will meet the in-significant-part requirement regardless of whether the QPP is imported back into the United States before the lease, rental, license, sale, exchange, or other disposition of that property.

The notice provides that the determination of whether the taxpayer's activity within the United States is "substantial in nature" must be made by taking into account "all the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's activity in the United States, the nature of the property, and the nature of the activity the taxpayer performs in

the United States." The notice specifically provides that if a taxpayer purchases unrefined oil extracted outside the United States by an unrelated party and the taxpayer refines the oil in the United States, the refining of the oil by the taxpayer in the United States will be treated as manufacturing, production, growth, or extraction that is substantial in nature within the United States.

**2. Cost safe harbor.** Under the cost safe harbor test, the in significant part requirement would be met if the conversion costs (direct labor and related factory burden) incurred by the taxpayer in the United States for the manufacture, production, growth, and extraction of the QPP are at least 20 percent of the taxpayer's total cost for the property.

**3. Excluded costs.** The notice provides that two categories of activities or costs generally are not taken into account in applying either the substantial-in-nature test or the cost safe harbor test:

- packaging, repackaging, labeling, and minor assembly activities or costs; and
- design and development activities or costs and the costs of the creation or licensing of intangible property with respect to production of tangible QPP; however, those activities or costs can be taken into account when the QPP is computer software or sound recordings, because those types of QPP are themselves regarded as intangible property.

#### Observations

Packaging, labeling, and assembly. The notice is confusing with respect to the excluded activities/costs. Although some statements in the notice assert that those activities and costs cannot be taken into account in any respect in applying either version of the in-significant-part test, other statements in the notice, particularly regarding the substantial-in-nature test, seem to indicate that those activities and costs may be taken into account so long as they are not the only activities or costs on which the taxpayer is relying for purposes of meeting the in-significant-part requirement. For example, the notice's statement of the rules provides that "packaging, repackaging, labeling, and minor assembly operations do not qualify as substantial in nature," and the explanatory section of the notice describes Treasury's desire to prevent qualification when a taxpayer's U.S. activities consist "solely of affixing a label to a plastic bottle otherwise manufactured entirely outside the United States." That leaves open the question of whether the label operation could be taken into account in combination with other U.S. activities in determining whether the overall U.S. operations are substantial in nature. That approach would be a reasonable one, because the labor required to carry out assembly, packaging, and labeling functions makes for the creation of very real U.S. manufacturing jobs.

**Inconsistency with section 263A.** Under section 263A, packaging has been regarded as a production activity. Moreover, the "production" of packaging materials and the use of those materials in packaging property have been regarded as production within the meaning of section 263A. For example, in LTR 200328002, *Dec 2003-1640*, 2003 TNT 134-20, the IRS ruled that taxpayers providing packaging services to unrelated customers were producers within the meaning of section 263A.

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Thus, absent a change in the administration of section 263A, companies engaged in packaging and minor assembly might be regarded as producers for purposes of section 263A, but not for 199.

Also, under section 263A, a taxpayer that engages in more than de minimis production activities is regarded as a producer for purposes of section 263A. More than de minimis production is generally defined under a 10 percent test. As a result, some taxpayers may be regarded as having more than de minimis production activities for purposes of section 263A, but may not meet the 20 percent safe harbor under the notice.

**Design and development.** The notice asserts that design and development activities do not constitute manufacturing activities for purposes of the significant part test for all tangible personal property (except for computer software and sound recordings) because those activities produce an intangible asset (the design) rather than tangible personal property. That is a surprising assertion for several reasons.

First, the assertion suggests that a manufactured product should be broken down into a tangible component and an intangible component for purposes of applying section 199. Under the tax law, however, intangible components of tangible goods generally are not separately recognized. That is, it is generally accepted that the profits from the sale of goods with embedded intangibles are treated in their entirety as profits from the sale of tangible goods. Thus, the idea that the costs of developing intangibles associated with such a product are not manufacturing costs is novel and should be reexamined.

Second, the research, development, and marketing functions associated with a product's design and sale also mean real jobs in the United States. The idea that some manufacturing jobs (those associated with factory production) should be favored over other manufacturing jobs (for example, those associated with product design) warrants attention and discussion.

Third, this approach represents a departure from that taken in the EIT regime, under which not more than 50 percent of the fair market value of a product could be attributable to articles manufactured, produced, grown, or extracted outside the United States for the product to be eligible for the EIT exclusion. That meant that taxpayers could obtain an EIT benefit for export property largely produced outside the United States but for which value was attributable to U.S.-based intangibles (for example, design, trademarks, or trade name). That new approach would indicate clearly that the QPAD will not serve as a substitute for benefits previously derived under the EIT regime by at least some taxpayers.

#### E. 'United States'

While the statute does not define "United States" for purposes of the QPAD, the notice defines the term as: the 50 states, the District of Columbia, the territorial waters of the United States, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, for the exploration and exploitation of natural resources. The notice provides that the term "United States" does not

include possessions and territories of the United States or the airspace over the United States.

#### F. 'Derived From' Various Activities

The statute provides that DPCGR "means gross receipts of the taxpayer which are derived from any lease, license, sale, exchange, or other disposition" of QPP. (Emphasis added.) The statute, however, does not provide a definition or method for purposes of determining what constitutes gross receipts derived from those types of transactions.

The notice provides that gross receipts derived from the above-mentioned activities are limited to *direct proceeds* from the lease, rental, license, sale, exchange, or other disposition of QPP. The notice also indicates that the proceeds from business interruption insurance and payments not to produce are treated as gross receipts "derived from the lease, rental, license, sale, exchange, or other disposition" of QPP to the extent the payments are substitutes for gross receipts that would qualify as DPCGR.

The notice further provides that, for purposes of the "derived from the lease, rental, license, sale, exchange, or other disposition" requirement, existing federal income tax law principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, or whether it is a service. As an example, the notice makes reference to Rev. Rul. 88-65, 1988-2 C.B. 32, which treats a short-term lease as a service.

#### Observations

Gross receipts of a taxpayer that are considered derived from "any lease, license, sale, exchange, or other disposition" can qualify for the QPAD, but gross receipts that are considered derived from a service cannot. Therefore, pressure will be placed on the characterization of transactions as either services or sales of goods, or, conversely, as either services or leases or licenses. Those characterization issues are not new in the tax law. They have long been important to the treatment of various international transactions for many different purposes and, until recently, were important to the treatment of advance payments in transactions like those considered in Rev. Proc. 71-21. Those character determinations have been difficult and controversial in the past and will likely be very difficult for the many taxpayers that for the first time will have to make those distinctions for purposes of the QPAD.

#### G. Allocating Gross Receipts: Embedded Services

The statute does not provide any rules regarding the treatment of transactions with "embedded services" — that is, transactions in which the price of a service is included in the amount charged for a lease, rental, license, sale, exchange, or other disposition of property.

The notice, however, provides that for an embedded service, DPCGR includes only the receipts from the lease, rental, license, sale, exchange, or other disposition of the property and not any receipts attributable to the embedded service. The notice provides two exceptions to the general rule regarding embedded services.

- **Qualified warranty exception.** A taxpayer may include in DPCGR (assuming all requirements of

section 199(c) are met) gross receipts from a "qualified warranty." For purposes of this exception, the term "qualified warranty" means a warranty that is provided in connection with the sale of qualifying production property if: (1) in the normal course of its business the charge for the warranty is included in the price charged for lease, rental, license, sale, exchange, or other disposition of the qualifying production property; and (2) the warranty is neither separately offered by the taxpayer nor separately bargained for with the customer — that is, the customer cannot purchase the qualifying production property without the warranty.

- **De minimis exception.** If the amount of gross receipts from embedded services is less than 5 percent of the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the property, the amount of gross receipts from embedded services would qualify as DPGR. For purposes of applying the de minimis test, gross receipts from qualified warranties are not treated as gross receipts for services.

#### Observations

Many taxpayers conduct transactions that are best characterized as a lease, license, sale, exchange, or other disposition, but that involve an embedded service. Under the general rule, those taxpayers for the first time will be required to allocate gross receipts between the qualifying components of their transactions and the nonqualifying components. That will necessitate new valuation analysis that has not been conducted before. Presumably, the IRS will be prepared to disallow the QPAD whenever it is arguably attributable to profit on any more-than-de minimis service.

#### H. Advertising Income

The statute does not provide any special rules regarding advertising receipts. The notice provides that advertising income attributable to the sale or other disposition of newspapers and magazines should be considered "derived from" the sale or other disposition of the newspaper and magazine. The notice acknowledges that the advertising income is "inextricably linked" to the gross receipts derived from the lease, rental, sale, exchange, or other disposition of the newspapers and magazines. For example, a newspaper manufacturer's receipts from an advertiser to publish display advertising or classified advertisements in its newspaper are treated as gross receipts derived from the sale of the newspaper for section 199 purposes.

#### Observations

Public comments by Treasury officials indicate that the specific reference to newspapers and magazines does not necessarily restrict this rule from applying in the qualified film context (for example, to television shows and movies). When the guidance was issued, however, Treasury had not yet heard from the television or movie industries, and therefore did not believe it had sufficient information to extend the rule. It is likely such an extension will receive additional consideration during the next round of guidance.

#### I. Computer Software Income

The statute provides that "computer software" qualifies as QPP. The statute does not provide any special rules regarding when gross receipts can be considered derived from the lease, license, sale, exchange, or other disposition of computer software.

The notice provides that the determination of whether gross receipts can be considered derived from the lease, license, sale, exchange, or other disposition of computer software generally depends on all the facts and circumstances. The form adopted by the parties to the transaction, the classification of the transaction under copyright law, and the physical or electronic medium used to effectuate the transfer are not determinative.

More specifically, the notice provides that DPGR derived from computer software do not include gross receipts from Internet access services, online services, customer support, telephone services, games played through a Web site, provider-controlled software online access services, and other services that do not constitute the lease, rental, license, sale, exchange, or other disposition of computer software that was developed by the taxpayer. The notice characterizes receipts from those transactions as receipts from services. The notice provides additional guidance regarding the definition of "computer software," which is discussed below.

#### Observations

The notice grapples with the difficult service versus sale (or license) characterization issue and attempts to draw a bright line for software transactions by concluding outright that DPGR do not include gross receipts from "Internet access services, online services, customer support, telephone services, games played through a website, provider-controlled software online access services, and other services that do not constitute the lease, rental, license, sale, exchange, or other disposition of computer software that was developed by the taxpayer." On the other hand, receipts from transactions in which software is sold to customers who download the software from the Internet qualify as DPGR, according to the notice. Thus, while the statute provides that "any computer software" qualifies as QPP, Treasury will apparently draw distinctions between software transactions treated as transfers of goods, which can potentially qualify for the section 199 benefit, and software transactions treated as services, which cannot.

The notice appears to focus the question of whether an Internet software transaction gives rise to DPGR on whether or not an installation or download takes place on the customer's computer. Whether that factor would also be determinative when an installation is more than momentary but less than permanent, and thus when the transaction might be characterized as a lease or license of the software, is not yet clear. Whether the download distinction is intended to be the critical distinction in all cases is also less than clear.

Taxpayers currently providing access to data, information, games, or utilities over the Internet may want to consider modifying their business practice so that it is clear that gross receipts are derived from the provision of computer code that will reside on a customer's computer at least temporarily.

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**V. Defining QPP, Film, and Other Activities**

"Qualifying production property" is defined as tangible personal property, any computer software, and sound recordings (as described in section 168(f)(4)).

**A. Tangible Personal Property**

The term "tangible personal property" for this purpose is any tangible property other than land, buildings, and structural components of buildings. Intangible property such as patents, copyrights, and subscription lists are generally excluded as well. That definition is derived primarily from the investment tax credit rules in Treas. reg. section 1.48-1(c). Consistent with that usage, the notice provides that local law is not controlling for purposes of determining whether property is tangible personal property under the statute.

Examples of tangible personal property include:

- clothing;
- goods;
- food;
- books;
- magazines;
- newspapers;
- production machinery;
- printing presses;
- transportation and office equipment;
- refrigerators;
- grocery counters;
- testing equipment;
- display racks and shelves;
- neon and other signs;
- gasoline pumps;
- hydraulic car lifts; and
- automatic vending machines.

1. **Intellectual and creative property.** "Tangible personal property" excludes any property otherwise given specific treatment under section 199. As a result, qualified films, computer software, and sound recordings are not tangible personal property for purposes of the new law. However, the tangible medium on which that property is fixed is tangible personal property (for example, video cassettes, computer diskettes, or other similar tangible items). Likewise, books, magazines, newspapers, and similar intellectual or creative property embodied on any tangible medium and mass distributed may meet the definition of tangible personal property as well.

**Observations**

All types of tangible property held for sale, investment, or use by a taxpayer in its trade or business will generally meet the definition of qualifying production property provided the property is manufactured, produced, grown, or extracted by the taxpayer within the United States and the taxpayer's level of activity in this regard meets the in whole or in significant part threshold. That is true even if the property was not used in a qualified production activity.

Regarding intellectual and creative property not specifically identified under section 199 (that is, qualified films, computer software, and sound recordings), the means by which the property is distributed may control whether the taxpayer qualifies for the production activity deduction. For example, gross receipts derived from the sale of magazine subscriptions and related advertising

qualifies as domestic production gross receipts provided the words are embodied on a tangible medium. However, income from online subscriptions and advertising to the very same publication likely fails to qualify because the intellectual or creative property is not affixed to a tangible medium. That anomaly appears to frustrate the intent of the law, which seeks to provide an incentive for production activity within the United States, including researching, preparing, and writing intellectual and creative property irrespective of media on which it is presented.

**B. Computer Software**

The term "computer software" means 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. Computer software also includes the machine-readable coding for video games and similar programs, regardless of whether the program is designed to operate on a "computer" (as defined in section 168(i)(2)(B)). Computer programs of all classes meet the definition of computer software, including:

- operating systems;
- executive systems;
- monitors;
- compilers and translators;
- assembly routines;
- utility programs; and
- application programs.

1. **Bifurcating tangible medium from software.** If the medium in which the software is contained (whether written, magnetic, or otherwise) is tangible, the medium is considered tangible personal property for purposes of section 199.

*Example:* A taxpayer develops a software program that it reproduces and sells on diskettes. The program fixed on the diskette is treated as computer software, and the diskette is treated as tangible personal property.

2. **Incidental and ancillary rights.** The term "computer software" also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software.

*Example:* A trademark or trade name acquired to effect the acquisition (or right to use) a specific program in a taxpayer's trade or business is considered computer software for section 199 purposes, provided the property is not acquired for the purpose of marketing the software.

3. **Certain databases excluded.** Computer software does not include any data or information base unless the data base or item is in the public domain and is incidental to a computer program. For that purpose, a copyrighted or proprietary data or information base is treated as in the public domain if its availability through the computer program does not contribute significantly to the cost of the program.

**Example:** If a word processing program includes a dictionary feature that may be used to spellcheck a document or any portion thereof, the entire program (including the dictionary feature) is computer software regardless of the form in which the dictionary feature is maintained or stored.

#### Observations

In the case of a taxpayer engaged in both software development and the manufacture of the distributable tangible medium, each production activity must separately meet the "manufactured, produced, grown, or extracted in whole or significant part within the United States" requirement. In that situation, the sole effect of that bifurcation rule is that design and development activities associated with the production of the tangible medium will be disregarded, while design and development activities associated with the software will be taken into account. As discussed below in the section pertaining to qualified film, the bifurcation requirement may have a significant effect on companies that do not develop the original software but produce and sell copies of the software.

#### C. Sound Recordings

The term "sound recordings" means any work that result from the fixation of a series of musical, spoken, or other sounds. The term "sound recordings" does not include the creation of copyrighted material in a form other than a sound recording, such as lyrics or music written on paper or other similar material.

**1. Bifurcating tangible medium from sound recordings.** If the medium (such as compact discs, tapes, or other phonorecordings) in which the sounds are embodied is tangible, the medium is considered tangible personal property for purposes of section 199.

**Example:** Taxpayer records music that it reproduces and sells on compact disc. The music fixed on the compact disc is treated as sound recordings, and the compact disc is treated as tangible personal property.

#### Observations

Treasury has not yet addressed whether or not the medium of intended exploitation for sound recordings (for example, downloads, MP3s, digital remastering, and so forth) or their means of distribution affect their qualification under section 199. Congressional intent is clear on that question regarding film and video tape. The legislative history states that the nature of the material on which the property is embodied and the methods and means of distribution do not affect their qualification as qualified film. Section 168(f)(1) similarly suggests a broad definition of sound recordings "regardless of the nature of the material . . . in which such sounds are embodied." Thus, it is likely that digital music, audio, and other sound recordings, such as MP3s or similar items, meet the definition of QPP.

As discussed below in the section pertaining to qualified film, the requirement to bifurcate the tangible medium from the sound recording may have a significant effect on companies that do not produce the sound recording but merely mass produce and sell copies of the recordings.

#### D. Qualified Film

DPGR includes the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of *any qualified film produced by the taxpayer*.

Qualified film means any motion picture film, videotape, or live or delayed television programming (excluding some sexually explicit films), if at least 50 percent of the total compensation relating to the production of the film is compensation for services performed in the United States by actors, production personnel, directors, and producers.

**1. Revenue streams from qualified film.** Films produce several different types of revenue streams: income from film rentals, income from film sales (that is, when a film producer sells copies of film directly to the public), income from licensing of film, income from the licensing of film characters, and income from the sale of film-themed merchandise. In determining DPGR, the notice specifically includes some of those revenue streams, with some limitations, and specifically excludes other revenue streams. Specifically excluded are revenue from film-themed merchandise and the license of the right to use film characters.

**2. Need to bifurcate between the master copy and the tangible personal property embodying the film.** Treasury explains in the notice that qualified film is limited to the master copy of the film (or other copy from which the holder is licensed to make and produce copies). In other words, qualified film does not include the tangible personal property embodying the film, such as DVDs or video cassettes. The examples provided by Treasury are as follows:

**Example 1:** A produces qualified film, fixes the film to a tangible medium purchased from an unrelated taxpayer, and leases or licenses the qualified film and medium containing the qualified film to unrelated commercial theaters. A's gross receipts from the lease or license of the qualified film are "derived from" (1) the lease of tangible personal property (tangible property on which the copy is fixed) and (2) the license of the qualified film (the right to publicly display the film). Gross receipts received from the lease of the tangible personal property do not constitute DPGR, because A did not produce the tangible property. But gross receipts from the license of the qualified film do constitute DPGR, as A produced the film.

**Example 2:** A licenses qualified film to unrelated taxpayer B, and B reproduces the film on DVDs or video cassettes manufactured by B in the United States. B's gross receipts from the sale of the DVDs and video cassettes are derived from the sale of (1) tangible personal property (DVDs and video cassettes) and (2) the qualified film (the motion picture fixed on the DVDs and video cassettes). For B, gross receipts from the sale of the DVDs and video cassettes constitute DPGR, because B produced the tangible property. But gross receipts received from the sale of the qualified film attached to the DVDs and video cassettes do not constitute DPGR for B, because B did not produce the qualified film.

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## Observations

The requirement to bifurcate the intangible from the tangible medium in which it is embedded — which we have discussed in connection with software, sound recordings, and film — stands in stark contrast to the rules for the production of other items of tangible personal property.

In informal conversations, Treasury has stated that the bifurcation was intended to be taxpayer favorable. Apparently, some taxpayers producing the mass-produced tangible medium questioned whether they would be regarded as producers for purposes of section 199. The bifurcation of the intangible and the tangible medium was intended to ensure that those taxpayers would be regarded as producers. While some taxpayers may benefit by this bifurcation rule, depending on how it is interpreted, others may be negatively affected.

It is not immediately clear from the notice how the bifurcation is to be applied to a taxpayer that does not produce the film, but manufactures the mass-produced copies under a licensing agreement. Under one interpretation, the taxpayer's QPAD could be significantly curtailed.

Consider this example: Taxpayer A licenses a qualified film to Taxpayer B. Taxpayer B manufactures DVDs containing popular films as well as blank DVDs. Under the terms of the license, Taxpayer B pays Taxpayer A \$8 each time it affixes the film to a DVD. Taxpayer B's cost of manufacturing a DVD is \$4 and the cost of affixing a film to the DVD is \$3. Thus, Taxpayer B's cost of manufacturing DVDs containing popular films is \$15. Taxpayer B sells each finished product for \$20. Assume that blank DVDs are sold for \$4.50.

Under the notice, the revenue attributable to the sale of the DVD is DPGR, but the revenue attributable to the sale of the licensed film is not DPGR, because Taxpayer B did not produce the film. Taxpayer B enjoys \$5 of profit from selling the DVD on which the popular film is recorded.

Because the blank DVDs are manufactured for \$4 and sold for \$4.50, it would appear that, at a minimum, the 50 cents of profit attributable to the manufacture of the DVD is DPGR. Presumably, an additional portion of the profit is attributable to the activities related to the recording of the film on the DVD. Assuming those activities constitute production, the profit attributable to them should be DPGR. However, in informal discussions, government officials have stated that some portion of the profit is attributable to the markup on the sale of the film that was not produced by Taxpayer B, and is, therefore, not DPGR. Government officials have noted that it is the taxpayer's burden to establish the portion of the gross receipts qualifying as DPGR. If that interpretation of the bifurcation rule were ultimately adopted, taxpayers in the position of Taxpayer B would receive only a partial QPAD even if 100 percent of their activities related to the production of mass-produced DVDs in the United States.

Such a bifurcation rule does not apply to the manufacture of property other than property containing software, sound recordings, or film. For example, a car manufacturer is not required to bifurcate its sales proceeds between the portion of the car that it manufactured

and the components of the car. To illustrate, assume Taxpayer A manufactures car engines that it sells to Taxpayer B for \$500. Taxpayer B includes the engine in a car that it manufactures. Taxpayer B expends an additional \$7,500 manufacturing the car. The car is sold for \$10,000. The entire profit of \$2,000 qualifies for the QPAD. Even when the cost of the component at issue is significant in comparison to the sales price, bifurcation is not required in situations involving purely tangible personal property. For example, when a jewelry manufacturer purchases a diamond for \$1,000 and spends \$500 to produce a ring containing the diamond, which it, in turn, sells for \$2,500, presumably the entire \$1,000 profit would be treated as DPGR. Finally, in cases involving intangibles other than software, sound recordings, and film, no bifurcation is required. For example, a book publisher is not required to allocate gross receipts between the tangible medium (the book) and the underlying manuscript.

It is not clear why the license of the film, for example, would not be treated the same as the acquisition of any other raw material used in a production process. The cost of the license, like the cost of the engine, diamond, or manuscript, should offset DPGR as part of the CGS. There should not, however, be a disqualification of a portion of the profit from DPGR.

The bifurcation of the intangible and the tangible medium also will result in complex issues regarding the allocation of expenses.

It should be noted that in the example in the notice, Taxpayer B manufactured DVDs and recorded films on the DVDs. Taxpayer B is regarded as a producer. An interesting issue not addressed by the notice is whether a taxpayer that purchases, rather than produces, DVDs and records film on them will be regarded as a producer for purposes of section 199. The next round of guidance is expected to address that and similar issues.

3. **Television programming.** The notice is silent on whether the advertising revenue related to television programming is included in DPGR.

**Observations**

As discussed above, advertising revenue is included in the DPGR related to the production of newspapers. In the case of local programming, advertising may be the only revenue derived from that programming. Accordingly, if advertising revenue does not qualify as DPGR, the extension of section 199 to that programming will be an empty gesture.

4. **Who is the producer?** The notice does not contain specific rules related to when a taxpayer will be treated as the producer of a film when a taxpayer hires a third party to assist in the production.

**Observations**

The contract manufacturing rules set forth in the notice regarding tangible personal property are also applicable to film. Under common industry practice, a film studio will hire an independent production company to produce a film. Generally, the studio retains ownership of the screenplay and rights to the film, including exploitation and distribution rights. All financing of the production, as well as all material production decisions, are made solely by the studio. The foregoing would appear to be sufficient benefits and burdens of

ownership to establish that the studio ought to be regarded as the producer, and therefore eligible for the QPAD. On the other hand, the production company would not be entitled to the QPAD.

**5. Compensation for services and 50 percent rule.** For any film to be qualified film for purposes of section 199, at least 50 percent of the total compensation relating to the production of the film must be compensation for services performed in the United States by actors, production personnel, directors, and producers. According to the notice, "compensation for services" includes all payments for services performed by actors, production personnel, directors, and producers, including participations and residuals. "Production personnel" includes those people who are directly involved in the production of the film, such as writers, choreographers, and composers providing services during the production of the film, as well as casting agents, camera operators, set designers, lighting technicians, make-up artists, and similar personnel. Not included as production personnel for purposes of determining compensation for services in the United States are individuals whose activities are ancillary to the production, such as advertisers and promoters, distributors, studio administrators and managers, studio security personnel, and personal assistants to actors.

Regarding residuals and participations, if a taxpayer uses the income forecast method of section 167(g) and capitalizes residuals and participations into the adjusted basis of the qualified film, the taxpayer must use the same estimate of residuals and participations for section 199 that is used for section 167(g). If a taxpayer excludes participations and residuals from the adjusted basis of the qualified film, the taxpayer must determine the compensation expected to be paid as residuals and participations based on the total forecasted income used in determining income forecast depreciation.

The notice does not provide a specific allocation method for compensation relating to the production of the film within and outside of the United States. Instead, the notice permits the taxpayer to use any reasonable method for making the allocation, so long as it is used consistently.

#### E. Producing Electricity, Natural Gas, or Water

Activities related to the production of electricity, natural gas, and potable water are included under section 199. Specifically, DPGR includes the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States. But the statute places a limitation on electricity, natural gas, and potable water that is inapplicable to the other categories of tangible personal property. Although the income related to the *production* of electricity, natural gas, and potable water is included in DPGR, the income related to the *transmission and distribution* of electricity, natural gas, and potable water may not be included in DPGR.

**1. Need to bifurcate income between production and distribution activities.** The notice recognizes that an integrated producer that produces and delivers electricity, natural gas, or potable water must allocate its gross receipts between: (1) production, which qualifies as

DPGR, and (2) distribution and transmission, which do not qualify as DPGR. The notice establishes a de minimis rule for integrated producers when gross receipts attributable to transmission and distribution of electricity, natural gas, and potable water are less than 5 percent of the gross receipts from the sale of such property. In those cases, gross receipts attributable to the transmission and distribution of the property will be considered DPGR for purposes of section 199.

**2. Natural gas.** For purposes of section 199, the notice defines the term "natural gas" in a manner consistent with section 613A(e)(2) and includes only natural gas extracted from a natural deposit. It does not include, for example, methane gas extracted from a landfill. Natural gas production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline-quality gas. Gross receipts attributable to the transmission of pipeline-quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company's city gate (or to another customer) are not DPGR. Likewise, gross receipts of a local gas distribution company attributable to distribution from the city gate to the local customers are not DPGR.

**3. Potable water.** The term "potable water" means un-bottled drinking water. Production activities include the acquisition, collection, and storage of raw water (untreated water); transportation of raw water to a treatment facility; and treatment of the water at the facility. However, after the water has been treated, storage and delivery of the water will not be considered qualified production activities.

#### Observations

While Treasury requires the allocation of gross receipts between qualified production activities and transmission and distribution of electricity, natural gas, and potable water, the notice does not specifically suggest a method for making the allocation. One commentator suggested performing that allocation based on principles used for regulatory purposes. However, the extent to which an allocation based on regulatory accounting will be accepted or required is unclear. Moreover, utilities will be presented with many of the issues common to all producers of tangible personal property. For example, some utilities both produce electricity or gas and acquire electricity or gas for resale. Allocations between produced and purchased property will be necessary. Finally, some utilities have electricity or gas produced for them under a contract and are treated as the producers of the property for purposes of section 263A. A determination of whether, under the same facts, those utilities are producers for purposes of section 199 will require a benefits-and-burdens-of-ownership analysis.

#### F. Construction Performed in the United States

Section 199(c)(4)(A)(ii) defines the term "domestic production gross receipts" to include the gross receipts of the taxpayer that are *derived from construction performed in the United States*. Under the notice, four requirements must be met to obtain a QPAD related to construction activities:

- the construction must relate to "real property";

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- the construction must be performed by a taxpayer engaged in a construction trade or business;
- the taxpayer must engage in "construction activities"; and
- the gross receipts must be "derived from" construction.

1. **Construction of 'real property.'** The notice explains that to qualify as construction under section 199, the construction must be of real property, which is defined as:

- residential and commercial buildings (including the structural components of such buildings);
- inherently permanent structures other than tangible personal property in the nature of machinery;
- inherently permanent land improvements; and
- infrastructure.

The notice defines "infrastructure," borrowing from sections 168(j)(4)(C)(ii) and Treas. reg. section 1.263A-12(e)(2)(iii), to include roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, and wiring. Inherently permanent oil and gas platforms are also specifically identified as infrastructure for purposes of section 199.

**Observations**

Before the publication of the notice, a commentator suggested that construction of real property ought to be broadly construed. The commentator argued that the term "infrastructure" should include not only public work projects, such as roads and bridges, but also the construction of plant processes and equipment, such as heating and ventilation systems. The notice appears to have rejected the inclusion of plant equipment in real property while including heating and ventilation systems. Production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs are all defined as tangible personal property in the notice.

The notice does include structural components of buildings in real property. Definitions under sections such as 48 and 263A would include in the definition of "structural components of buildings" heating and ventilation systems, as well as walls, partitions, doors, wiring, plumbing, pipes and ducts, elevators and escalators, and similar property.

The notice does not provide a definition of inherently permanent structures. One would assume that this category would be defined at least as broadly as it is in section 263A, and perhaps as broadly as it is in section 48. Thus, inherently permanent structures should include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as special foundations, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, and grain storage bins and silos. The notice does provide that inherently permanent structures do not include property in the nature of machinery, such as gasoline pumps, hydraulic car lifts, and automatic vending machines.

The notice does not define inherently permanent land improvements; however, for several other purposes of the code, land improvements have included swimming pools, paved parking areas, wharves and docks, bridges, and fences.

2. **Tangible personal property provided in connection with construction activities.** Although tangible personal property (for example, appliances, furniture, and fixtures) is not real property for purposes of section 199, the notice establishes a de minimis rule for gross receipts derived from construction. If more than 95 percent of the total gross receipts derived from a construction project are derived from real property (as defined in Treas. reg. section 1.263A-8(c)), the total gross receipts derived by the taxpayer from the construction project can be treated as DPGR from construction. That rule in effect relieves the taxpayer of the burden of breaking out tangible property relating to the construction project to the extent that the tangible property accounts for less than 5 percent of the gross receipts.

For example, a home builder that sells homes containing appliances may treat the entire sales proceeds as DPGR provided that less than 5 percent of the gross receipts are "derived from" the appliances (and any other tangible personal property). The notice does not explain how the home builder is to determine the amount of the gross receipts "derived from" the tangible personal property.

3. **Performed by a taxpayer engaged in a 'construction business.'** The notice provides that only taxpayers engaged in a trade or business that is considered construction for purposes of the NAICS may claim the benefit of a QPAD related to construction activities. Under the NAICS definitions, the construction sector includes establishments that are primarily engaged in a variety of activities, including land development, land subdivision, general contracting, infrastructure construction, and many specialty subcontracting trades.

Specifically excepted from the NAICS construction sector are companies that are primarily engaged in businesses other than construction that also engage in construction using their own employees, for their own account and use. For example, a specialty contractor installing telecommunications and utility networks is included in the construction sector. However, telecommunication companies or utilities performing the same work on their own account are not included in the construction sector.

**Observations**

The requirement that the construction activities be performed by a taxpayer engaged in the trade or business of construction does not appear to have its genesis in the statute or legislative history. The addition of that requirement might be viewed as a rejection of a commentator's request. Specifically, one commentator inquired whether the installation, construction, operation, and maintenance of fiber optic cable that is permanently installed and characterized as depreciable real property qualifies as construction under section 199. If so, the gross receipts derived from the sale or lease of an indefeasible right to use of fiber optic cable and cable capacity may qualify as

DIPGR derived from construction performed in the United States. The notice appears to have rejected that view.

The notice does not explain why Treasury and the IRS limited the construction activities to which section 199 might apply. The result is that a taxpayer that self-constructs real property is not eligible for a QPAD for its construction activities, while a taxpayer constructing identical real property on behalf of a customer may be entitled to a QPAD for its construction activities. To the extent that a portion of those tax savings is passed on from the contractor to the customer, that could create a disparity between self-constructed and purchased assets.

It is interesting that Treasury's interpretation of section 199 could result in the creation of such a disparity because the largest tax act prior to this legislation — the Tax Reform Act of 1986 (TRA86) — attempted to eliminate such a disparity. Specifically, section 263A, enacted as part of the TRA86, was intended to place purchased assets on equal footing with self-constructed assets. Before the TRA86, fewer costs were generally capitalized into self-constructed assets than were included in the basis of purchased assets. As a result, some taxpayers were motivated by tax considerations to self-construct — rather than purchase — property even though that did not result in the most efficient allocation of economic resources. The government's interpretation of section 199 might cause the reverse to occur: If a portion of the contractor's tax savings is passed on to the customer, tax considerations might motivate taxpayers to contract out work that they might be able to perform more efficiently in-house.

It is possible that Treasury and the IRS adopted the requirement that the taxpayer be engaged in a business that is considered construction for purposes of the NAICS to minimize a thornier issue, discussed below, related to what constitutes gross income "derived from" construction. Government officials have informally stated that for taxpayers engaged in multiple activities, the government might look to a "principal business activity" test such as that set forth in Rev. Proc. 2002-28, 2002-1 C.B. 815, Dec 2002-9029, 2002 TNT 72-6, a revenue procedure that extends the availability of the cash method of accounting to small taxpayers engaged in businesses described in certain NAICS codes. Under Rev. Proc. 2002-28, a taxpayer must "reasonably determine" whether its "principal business activity" is described in certain NAICS codes. The revenue procedure provides that the principal business activity is determined by the source of gross receipts under either a prior-year or three-year average test.

Finally, the notice may result in the placement of an increased importance on the selection of the NAICS code. Companies ought to anticipate scrutiny, by the examination function, of section 199 construction benefits claimed by companies that have selected a nonconstruction NAICS code. It should be noted that several companies engaged in construction activities may not have selected an NAICS code that adequately reflects these activities. Government officials have publicly stated if a taxpayer has not been using the appropriate NAICS code, the taxpayer would be "acting appropriately" by now selecting an NAICS code reflecting a construction activity.

4. More than one taxpayer may qualify as performing construction activities related to the same project. On a positive note, in contrast to the position taken in the contract manufacturing realm, in the case of construction, the explanation of the interim guidance set forth in the notice provides that the same construction activity may be used to qualify the income of two different taxpayers as QPAI. Specifically, the explanation provides that it is appropriate in certain situations for more than one taxpayer to be regarded as deriving gross receipts from construction with respect to the same activity and the same construction project. An example illustrates that both a general contractor and a subcontractor may qualify for a QPAD for the same project.

#### Observations

This is an extremely significant issue to the construction industry. Home builders and general contractors derive their income directly from the sale of constructed homes or contracts to construct property. The statute specifically does not require the taxpayer to do the actual constructing. In light of the importance of this issue to the industry, it is interesting that this discussion appears only in the "Explanation" and not in the "Interim Guidance" section of the notice.

The notice does not explicitly resolve the issue of whether land developers may qualify for the QPAD. The notice provides an example involving a land owner, a general contractor, and a subcontractor. The notice explains that while the general contractor and subcontractor may qualify for a QPAD, a land owner that does not engage in construction activities will not qualify. Comments of government officials at a public meeting held shortly after the release of the notice suggest that three or more tiers of companies engaged in construction activities may potentially qualify for a QPAD. Thus, for example, if a general contractor contracts with an electrical contractor that, in turn, subcontracts specialty electrical contracting to another contractor, all three parties could qualify for a QPAD. Presumably, a land developer engaged in activities considered construction for purposes of the NAICS codes would similarly qualify for the QPAD.

5. Qualifying construction activities. Activities performed in connection with a project to erect or substantially renovate real property qualify as construction for purposes of section 199. But according to the notice, tangential services, such as hauling trash and debris and delivering materials, do not qualify as a construction activity unless the taxpayer performing construction is also performing those tangential services in connection with the construction project. In other words, a taxpayer engaged solely in the tangential services of a construction project cannot claim gross receipts from those services as DIPGR.

According to the notice, activities, such as improving land (for example, grading and land-caping) and painting, will constitute construction only if those activities are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property. It is up to the taxpayer performing those activities to make a reasonable inquiry as to whether the activity relates to the erection or substantial renovation of real property.

## COMMENTARY / SPECIAL REPORT

Substantial renovation includes structural improvements, but not mere cosmetic changes, such as painting. The appropriate standard in determining whether there has been a substantial renovation of real property, according to Treasury, is the standard applied under section 263(a) to determine whether a taxpayer's activities result in permanent improvements or betterments of property, such that the cost of the activities must be capitalized. In following the section 263(a) standard, the notice specifically defines "substantial renovation" as the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or adapts the property to a new or different use.

To the extent that a particular activity is included in the definition of "engineering and architectural services," the activity will not qualify as construction for purposes of section 199(c)(4)(A)(ii).

6. What constitutes 'derived from construction'? Regarding gross receipts "derived from construction" performed in the United States, there is no requirement under section 199(c)(4)(A)(ii) that there be a "lease, rental, license, sale, exchange, or other disposition of" property as required by section 199(c)(4)(A)(i). The notice explains that gross receipts may be derived from construction only if derived from (1) a sale, exchange, or other disposition of the property constructed or (2) the performance of construction services. Treasury determined that lease or rental income related to property constructed by the taxpayer is not "derived from construction."

On a positive note, the notice explains that a sale, exchange, or other disposition of property need not occur immediately on completion of construction. As such, a taxpayer that constructs a building and leases it for several years before sale may qualify for a QPAD on the ultimate sale.

#### Observations

The exclusion of lease or rental income is surprising. A taxpayer constructing a building for sale looks to the sales proceeds for its recovery of costs and profit, while a taxpayer constructing a building for lease looks to the stream of rental income for recovery of costs and profit. In either instance, the taxpayer is engaged in construction activities resulting in U.S. jobs. One wonders whether the notice's exclusion of lease and rental income is consistent with the objectives of the statute.

Moreover, a literal reading of the statute suggests that the eligible category of income related to construction should be broader, not narrower, than the eligible category of income related to QPP, film, and utility property. The statute provides that DPCGR includes receipts "derived from any lease, rental, license, sale, exchange, or disposition of" the latter categories of property. The statute provides that receipts "derived from construction performed," without specific limitation, are DPCGR.

#### G. Engineering and Architectural Services

Section 199(c)(4)(A)(iii) defines "domestic production gross receipts" to include the gross receipts of the taxpayer that are derived from engineering or architectural services performed in the United States for construction projects in the United States.

For purposes of section 199, the definitions of the terms "engineering services" and "architectural services" generally follow the definitions in the section 924 regulations.

Engineering services in connection with any construction project include any professional services requiring engineering education, training, and experience, and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services, such as consultation, investigation, evaluation, planning, design, or responsible supervision of construction for the purpose of assuring compliance with plans, specifications, and design.

Architectural services in connection with any construction project include the offering or furnishing of any professional services, such as consultation, planning, aesthetic and structural design, and drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project.

#### Observations

Comments received by Treasury urged the government to adopt a broad and easily construed definition of "engineering services." The commentators suggested using the definition provided in Treas. reg. section 1.924(a)-11(e)(5).

1. Limitation to services provided in the United States for U.S. real property construction projects. In general, the notice requires that the engineering or architectural services must relate to real property and must be performed in the United States, and that the taxpayer providing those services must be able to substantiate that the services relate to a construction project within the United States. The notice also provides that DPCGR includes gross receipts derived from engineering or architectural services even if the planned construction project is not undertaken or is not completed.

The notice provides a de minimis exception for performance of services in the United States. If gross receipts derived from engineering or architectural services (1) performed outside the United States or (2) related to property other than real property for a construction project inside the United States total less than 5 percent of the total gross receipts of the taxpayer derived from engineering or architectural services performed by the taxpayer regarding the same construction project, the receipts will be treated as DPCGR.

#### Observations

The statute provides that the engineering and architectural services must be performed for "construction projects in the United States." The statute and legislative history do not specify whether "construction projects" refers to only the construction of real property or whether it also includes the construction of tangible personal property. In a separate section related to construction activities performed in the United States, the legislative history provides "for this purpose, construction activities include activities directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure." A government official has publicly commented that because the provision addressing

construction activities is limited to real property construction, the provision addressing engineering and architectural services related to construction projects should similarly be limited to real property construction.

Some have suggested that the language "construction activities include" should be read to mean that while construction activities include the defined categories of real property construction, it should not be read to limit construction activities to the defined categories. Moreover, because that language appears only for purposes of explaining the construction activities provision, and not the engineering and architectural services provision, some suggest that in any case it ought not to be read as limiting the engineering and architectural services provision. Accordingly, it has been suggested that the notice may be limiting the scope of the statute and excluding some companies intended to benefit from section 199.

#### H. Exception for Sales of Food and Beverages

Under the exception for sales of certain food and beverages, DPGR does not include gross receipts derived from the sale of food or beverages prepared by the taxpayer at a retail establishment. Several "exceptions to the exception" are available. The notice defines a "retail establishment" as real property leased, occupied, or otherwise used by the taxpayer in its trade or business of selling food or beverages to the public at which retail sales are made. The notice explains that this definition is similar to the definition of "retail space" under section 110 (relating to qualified lessee construction allowances for short-term leases). It is important to note that retail establishments used in the trade or business of selling food are not limited to dine-in establishments. The legislative history provides that retail establishments include carry-out restaurants as well as in-store bakeries at grocery stores.

1. Five percent de minimis rule. A facility will not be treated as a retail establishment if less than 5 percent of the food or beverages sold at that facility during the year are sold at retail.

##### Observations

Under the 5 percent de minimis rule, for example, a bread plant that bakes bread to sell at wholesale will not be treated as a retail establishment if it operates a "day-old" shop on the plant premises, provided that less than 5 percent of the bread baked at the plant during the year is sold at the day-old shop. Records will need to be maintained to establish qualification for this exception.

2. Dual-function facility rule. If more than 5 percent of the food or beverages prepared at a facility is sold at retail, the facility will be regarded as a retail establishment; however, it may allocate its gross receipts between gross receipts derived from wholesale activities (DPGR) and retail activities (non-DPGR).

##### Observations

Although not specifically discussed in the notice, costs will also be allocated between the DPGR and non-DPGR. The general cost allocation rules will apply. Based on comments by government officials, it may be possible that a simple allocation of costs based on gross receipts might be regarded as reasonable under the 801 method. In public comments and informal discussions, government officials have referred to this exception as a dual-

function rule similar to that for dual-function storage facilities under section 263A. Under section 263A, storage costs associated with a dual-function storage facility are allocated between what is effectively the retail and non-retail functions based on the ratio of retail sales to total sales.

#### VI. Cost Allocation

A company's DPGR must be offset by three categories of costs:

- the cost of goods sold that are allocable to those receipts;
- other deductions, expenses, or losses *directly allocable* to those receipts; and
- a ratable portion of other deductions, expenses, and losses that is *not directly allocable* to those receipts or another class of income.

Section 199(c)(2) states that Treasury shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. The notice provides a multiple-step process for dealing with the expense allocation question and provides multiple possible methods within each step.

#### A. Allocating Cost of Goods Sold

First, the notice provides that a taxpayer engaged in the sale of qualifying production property should allocate its expenses to CGS in accordance with the general principles of section 263A. Section 263A requires the capitalization of direct costs and, with few exceptions, the indirect costs that "directly benefit or are incurred by reason of" a production activity. In a typical scenario, a manufacturer would capitalize into inventory its direct material, direct labor, factory overhead, and a portion of "mixed service costs" (for example, general and administrative costs and non-section 174 engineering and design costs).

The notice contains a special rule for imported items or services. The cost of any item or service brought into the United States cannot be less than its value immediately on entering the United States. If the item is exported from the United States for further manufacture and then reimported, the increase in cost may not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States. "Value" means customs value as defined in section 1059A(b)(1).

The notice also provides that, if a taxpayer cannot specifically identify the CGS allocable to the DPGR, the taxpayer may make the allocation using a reasonable method. Situations in which a taxpayer might not be able to specifically identify CGS could include the following:

- the taxpayer produces QPP and also produces property in another country;
- the taxpayer produces QPP and engages in the packaging, repackaging, labeling, or minor assembly of other property;
- the taxpayer produces QPP and acquires property for resale; and
- the taxpayer produces QPP and sells it in connection with more-than-de minimis services.

## COMMENTARY / SPECIAL REPORT

Taxpayers using the simplified production method under section 263A will generally be unable to specifically identify CGS and, therefore, if engaging in both qualifying and nonqualifying activities, will be required to make a reasonable allocation of CGS. If the taxpayer uses a method to determine the allocable portion of its gross receipts derived from qualified production activities, the taxpayer must use the same method to determine the allocable CGS.

Although CGS is an inventory concept, the notice explains that for purposes of section 199, CGS also refers to the adjusted basis of noninventory QPP.

Small taxpayers (those with average annual gross receipts of \$5 million or less) may use a single simplified method, described below, to allocate its CGS and other deductions, expenses, and losses.

### B. Allocating Deductions, Expenses, and Losses

The costs that are not allocated to CGS under section 263A may include section 174 costs; selling, marketing, advertising, warranty expenses; policymaking costs; the portion of the mixed service costs that were not allocated to noncapitalizable activities; interest; losses; and charitable contributions.

**1. Methods for Allocation and Apportionment of Deductions.** The notice provides three methods for allocating deductions (other than CGS) to qualified production activities. Those methods presumably will be used both by taxpayers not engaged in qualifying activities that do not involve the sale of goods and by taxpayers who sell goods but who have deductions to allocate and apportion other than deductions that factor into the cost of goods sold.

- **Section 861 method.** This method is available to all taxpayers and generally follows existing rules applicable to taxpayers required to determine taxable income from within and outside the United States. The notice provides that a taxpayer generally must allocate and apportion its deductions using the rules provided in the section 861 regulations. The notice states that, under the section 861 method, section 199 is treated as an "operative section" described in Treas. reg. section 1.861-8(f). Accordingly, the taxpayer applies the rules of the section 861 regulations to allocate and apportion deductions to gross income attributable to DPGR. In general, the section 861 regulations are applied on a single-entity basis, although the rules are applied on the basis of the affiliated group (as determined under the section 861 regulations) for certain expenses, such as interest expense and research and experimental expenses.

It is important to note that, according to the notice, a taxpayer using a particular method for allocating and apportioning costs under section 861 for purposes other than determining its QPBI (for example, for purposes of calculating its foreign tax credit limitation) must use the same particular method for allocating and apportioning those costs for purposes of section 199. This consistency rule mimics the consistency rule already present under the section 861 regulations. There are two special allocation rules under the section 861 method. Charitable

deductions must be ratably apportioned based on the relative amount of DPGR gross income and other gross income. Research and experimentation expenses must be allocated and apportioned in accordance with Treas. reg. section 1.861-17, without reference to the exclusive apportionment rule of Treas. reg. section 1.861-17(b).

- **Simplified deduction method.** This method is available only to taxpayers with average annual gross receipts (over the three prior years) of \$25 million or less. It provides a simplified formula that allocates deductions based on the ratio of the taxpayer's income derived from qualified production activities as compared to the taxpayer's income from all sources. A taxpayer electing this simplified deduction method must use that method for all deductions.
- **Small-business simplified overall method.** Under this method, both CGS and all other deductions are allocated based on the same ratio applicable under the second method. This method is available only to taxpayers with average annual gross receipts (over the three prior years) of \$5 million or less, and certain other small taxpayers that are permitted to use the cash method of accounting (that is, any taxpayer with average annual gross receipts of \$10 million or less that is not prohibited from using the cash method under section 448, including a partnership, an S corporation, a C corporation, or an individual).

### Observations

Although the notice provides three methods of allocating costs other than cost of goods sold, two of those three methods are available to small taxpayers. Thus, large taxpayers (taxpayers with average annual gross receipts exceeding \$25 million) have a single option: the section 861 method. Government officials have publicly stated that they believe more than 99 percent of C corporations will qualify as small taxpayers.

For taxpayers that must use the section 861 method and already use section 861 for other purposes, the consistency rule may require the taxpayer to reassess its choice of methods, because any given method may provide a favorable result for one purpose but an unfavorable result for another.

**2. Specific treatment of certain deductions.** Four special rules apply to all three methods for allocating and apportioning deductions:

- a section 165 loss related to property is allocated or apportioned to DPGR only if the proceeds from the sale of the property are, or would have been, DPGR;
- a section 172 net operating loss is not allocated or apportioned to DPGR;
- a deduction that is not attributable to the actual conduct of a trade or business (for example, the standard deduction or deduction for personal exemptions) is not allocated or apportioned to DPGR; and
- if non-DPGR is treated as DPGR under a safe harbor or de minimis rule under the notice, the deductions related to such non-DPGR must be allocated or apportioned to DPGR.

## VII. Wages-Paid Limitation

In general, the QPAD for any tax year is limited to 50 percent of the "W-2 wages" paid by the taxpayer during the calendar year that ends in that tax year. Therefore, fiscal year taxpayers will look to the wages paid throughout the calendar year ending within their fiscal year when determining this limitation.

For those purposes, the term "W-2 wages" generally means the sum of the aggregate amounts that are required to be reported on Form W-2 by the employer or those acting as agents for the employer with respect to:

- total wages, tips, and other compensation;
- employee salary reduction contributions to 401(k) arrangements and similar plans; and
- designated Roth IRA contributions for tax years beginning after December 31, 2005.

### A. Methods for Calculating W-2 Wages

Taxpayers do not currently determine, for payroll or income tax purposes, an amount that can be used for calculating the wage limit requirement without making some adjustments. The notice provides three alternative methods for making the required calculations:

- **Unmodified Box Method.** The taxpayer uses the lesser of the aggregate amount reported as (1) Wages, Tips, and Other Compensation (Box 1), or (2) Medicare Wages and Tips (Box 5) on all Forms W-2 filed with the Social Security Administration for all employees during the year.
- **Modified Box 1 Method.** The taxpayer reduces the aggregate amounts that are reported as Wages, Tips, and Other Compensation (Box 1) by both (1) amounts that are not wages for federal income tax withholding purposes and (2) amounts that are merely treated as wages for withholding purposes (for example, supplemental unemployment compensation benefits and certain forms of sick pay, among others). That amount is then increased by employee salary reduction contributions to 401(k) arrangements and similar plans.
- **Tracking Wages Method.** A taxpayer calculates the actual amount of wages subject to federal income tax withholding, subtracts supplemental unemployment compensation benefits that were included in that amount, and then adds employee salary reduction contributions to 401(k) arrangements and similar plans.

**1. Nonduplication rule.** Amounts that are treated as W-2 wages for a tax year under any method may not be treated as W-2 wages of any other tax year. For example, an amount of nonqualified deferred compensation that is treated as W-2 wages under the Unmodified Box Method for any tax year may not later be treated as W-2 wages in any other tax year.

#### Observations

Although the Unmodified Box Method is the easiest method available to determine the deduction limit, it will usually result in the lowest deduction limit. Taxpayers using the Modified Box 1 or Tracking Wages Methods will generally have a higher deduction limit. For example, under the Unmodified Box Method, employee salary reduction contributions to a 401(k) arrangement are not included in taxable wages, the amount that is

usually less than the Medicare wages amount on the Form W-2. However, both the Modified Box 1 and Tracking Wages Methods would increase the limitation for this amount. The Unmodified Box Method disregards all 401(k) deferrals, making the W-2 wages and the deduction limit lower than if these amounts were taken into account.

While there is currently no provision that would prohibit taxpayers from changing from one method of calculating W-2 wages to another in any given tax year, taxpayers making those changes will need to make additional calculations because of the nonduplication rule and the different treatment of nonqualified deferred compensation for income and Medicare tax purposes.

Because the W-2 wage limitation is computed on the taxpayer's entire wage base and the production activities deduction is based on a limited percentage of a net income number related only to qualified production activities, most taxpayers will not "bump into" the wage limitation.

### B. Employees of Taxpayer

According to the notice, the Forms W-2 used in determining the amount of the taxpayer's total W-2 wages under the methods described above include wages paid to employees or former employees of the taxpayer for employment by the taxpayer. Employees would include corporate officers and common-law employees, but not independent contractors.

Also, the determination of total W-2 wages may take into account any wages paid by another entity and reported by the other entity on Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. Consequently, an agent or statutory employer cannot use those amounts in its deduction limitation. For example, if the taxpayer is not the common-law employer of the payee but rather the statutory employer because of control of the payment of wages, that payment of wages may not be included in determining W-2 wages of the taxpayer. Likewise, if the taxpayer is paying wages as an agent of another entity to individuals who are not employees of the taxpayer, the wage may not be included in determining the W-2 wages of the taxpayer.

#### Observations

Essentially, the notice looks to the common-law employer to determine the taxpayer that can include payee wages for purposes of the section 199(b)(2) W-2 limitation. Compensation paid to independent contractors (and by those acting as agents or statutory employers) is excluded for those purposes. Taxpayers should be able to include the wages of all common-law employees, including:

- temporary employees from an employment agency;
- contract employees working under the supervision and control of the taxpayer; and
- certain employee-leasing arrangements.

Consistent with the intent of the legislation, the notice uses the common-law standard to coordinate W-2 wages for employment by the taxpayer with the taxpayer undertaking the qualified production activities.

## COMMENTARY / SPECIAL REPORT

## VIII. Special Rules

## A. Application to Expanded Affiliated Groups

In general, all members of an expanded affiliated group are treated as a single corporation for purposes of section 199. An EAG is an affiliated group of includable corporations as defined in section 1504(a) determined by substituting "50 percent" for "80 percent" each place it appears, and includes insurance companies and corporations that have made an election under the possessions tax credit rules.

A single QPAD is computed for the EAG, and is then allocated among members of the EAG. The statute provides that, except as provided in regulations, the QPAD is allocated among the members of the group in proportion to each member's respective amount (if any) of QPAI.

**1. Computation of EAG's QPAD.** Under the notice, the QPAD for an EAG is determined by aggregating each member's taxable income or loss, QPAI, and W-2 wages. For that purpose, a member's QPAI is the member's DPGR less the sum of the CGS allocable to such receipts and other costs required to be allocated under the notice, as discussed above. A member's QPAI may be positive or negative. A member's taxable income or loss and QPAI are determined by reference to the member's method of accounting. Under a special rule, for purposes of section 199, a consolidated group is treated as a single member of the EAG. That rule applies for all purposes, and thus will be used to compute the taxable income limitation and QPAI, and in allocating the QPAD to members of the EAG.

Based on the statutory exception in section 199(c)(7), DPGR does not include any gross receipts derived from related-party transactions if the property that is leased, licensed, or rented stays in the group. The notice does not explicitly address the treatment of other transactions between group members.

**Observations**

The treatment of transactions between members of an EAG deserves further development in regulations. Transactions between EAG members other than related-party leases, and so forth, apparently will be recognized even when the property remains in the EAG. If the EAG members do not file a consolidated return, then the sale should result in taxable income and QPAI, both taken into account in the year of the sale. Section 267 likely would defer any losses. If a sale occurs between EAG members who are members of a consolidated group,

Treas. reg. section 1.1502-13 provides that the resulting gain or loss is not taken into account in determining the selling member's income until a subsequent event occurs. Thus, the gain or loss should not be taken into account in determining the group's (or the member's) taxable income or QPAI. Specific guidance regarding the treatment of QPAI in that situation would be helpful.

**2. Attribution of activities.** According to the notice, Treasury believes that each member of an EAG should be treated as conducting the activities conducted by each other member for purposes of determining whether gross receipts are DPGR. Therefore, the notice establishes an attribution of activities rule under which "[e]ach member of an EAG is treated as conducting the activities conducted by each other member of the EAG." As a result, production activities engaged in by one member are attributed to another member even if the second member does not engage in qualified production activities.

**Example: Attribution of Activities.** A and B are members of an EAG. A manufactures QPP and sells it to B for \$100 in 2005. A's total costs allocated to the QPP are \$50. B resells the property to unrelated party C in 2005 for \$110. B incurs selling costs and other expenses of \$1. A's sale to B produces DPGR, because A is selling property that it manufactured. Ordinarily, B's sale to C would not produce DPGR, because B is merely a reseller. Under the attribution-of-activities rule, however, B is considered to be conducting the qualifying activities of fellow group member A. Consequently, both A and B have DPGR, assuming all other requirements of section 199 are satisfied. A will have QPAI of \$50 (\$100-\$50 costs) and B of \$9 (\$110-\$101 costs).

**3. Antiavoidance rule.** The notice states that EAGs cannot engage in transactions "with a princip[al] purpose of qualifying for, or modifying the amount of, the [QPAD]." If it is determined that those transactions have been entered into, adjustments must be made to eliminate the effect of the transaction on the computation of the QPAD.

**Observations**

Because the general rules recognize transactions between group members, rather than disregarding them as occurring between branches of a single corporation, Treasury and the IRS included an antiabuse rule to discourage transactions that have a tax avoidance purpose. The scope of the rule broadly includes transactions that attempt to qualify for or change the amount of the

## Example: Allocation of QPAD to Members of an EAG

Assume A owns 100 percent of B and A-B file a consolidated return. B owns 75 percent of C, so A-B-C constitute an EAG for section 199 purposes. In 2005 the A-B-C group determines that it is entitled to a QPAD of \$12. Separate company taxable income and QPAI are as follows:

|                | A   | B     | C   |
|----------------|-----|-------|-----|
| Taxable Income | 300 | (200) | 300 |
| QPAI           | 300 | (100) | 200 |

The deduction must be allocated to group members. Under the special rule, the A-B group is treated as a single EAG member, and that member's QPAI is 200. Consequently, the \$12 QPAD is allocated \$6 to A-B and \$6 to C. The entire \$6 allocated to A-B is then allocated to A, the only consolidated group member with QPAI. Without the special rule, the allocation would be different. The deduction would be allocated between A and C based on their amounts of QPAI (\$7.20 to A and \$4.80 to C), with no allocation to B.

deduction. The "a principal purpose" standard means the tax avoidance purpose must be one of the principal motivations for the transaction.

**4. Allocation of expanded affiliated group's QPAD.** The EAG's QPAD is allocated among members of the EAG in proportion to each member's QPAI, if any, regardless of whether the EAG member has taxable income or loss for the tax year and regardless of whether the EAG member has W-2 wages for the tax year. For allocation purposes, if a member has negative QPAI, the QPAI of the member shall be treated as zero. Under the special rule mentioned above, if the EAG includes members of a consolidated group, the consolidated group is treated as a single corporation for allocation purposes. Once the QPAD is allocated between nongroup members and the consolidated group, however, a further allocation of the group's portion of the deduction must be made among members of the consolidated group. (See examples of QPAD to members of an EAG on p. 980.)

**5. Partial-year members of the EAG.** Under the notice, a corporation must determine whether it is a member of an EAG on a daily basis. 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.

**6. Allocation of income and loss: partial-year members.** A partial-year member of an EAG is required to allocate its taxable income or loss, QPAI, and W-2 wages between the portion of the tax year during which it is a member of the EAG and the portion of the tax year during which it is not a member of the EAG. The corporation may use one of two allocation methods.

- **Pro rata allocation method.** Under the pro rata allocation method (the default method), an equal portion of each of the taxable income or loss, QPAI, and W-2 wages for the tax year is assigned to each day of the corporation's tax year. Then those items assigned to those days during which the corporation was a member of the EAG are aggregated.
- **Closing-of-the-books method.** Under the closing-of-the-books method, taxable income or loss, QPAI, and W-2 wages for the period during which the corporation was a member of the EAG are computed by treating the corporation's tax year as two separate tax years, the first of which ends at the close of the day on which the corporation's status as a member of the EAG changes and the second of which begins at the beginning of the day after the corporation's status as a member of the EAG changes. The closing of the books election is irrevocable and is made by filing a prescribed statement with a timely filed (including extensions) federal income tax return.

**7. Coordination with consolidated return allocation rules.** Special allocation rules under Treas. reg. section 1.1502-76 apply in the context of a consolidated group in which a subsidiary becomes or ceases to be a member during a consolidated return year. Those rules take precedence and are applied before any allocation is made pursuant to the rules under section 199 described above.

**Observations**

Because allocation under Treas. reg. section 1.1502-76 takes precedence, no further adjustment would appear

necessary when that rule covers all allocations to departing or joining members. If the entering or departing member does not join a consolidated group or owns a subsidiary that is not a member of the consolidated group, however, then the notice rule applies. There is no conformity requirement as to the methods used in this situation, so one method can be used for the Treas. reg. section 1.1502-76 allocation and another for section 199 purposes.

**8. Total QPAD for a corporation that is a member of an expanded affiliated group for some or all of its tax year.** If a corporation is a member of an EAG for its entire tax year, the corporation's QPAD for the tax year is the amount of the QPAD of the EAG allocated to the corporation by the EAG. If a corporation is a member of an EAG for a portion of its tax year, and is either not a member of any EAG, or is a member of another EAG, or both, for another portion of the tax year, the corporation's QPAD for the tax year is the sum of its QPADs for each portion of the tax year.

**9. Computation for members of EAG with different tax years.** If members of an EAG have different tax years, in determining the QPAD of a member (the computing member) with respect to each member of the EAG, the computing member is required to take into account the taxable income or loss, QPAI, and W-2 wages that are both (1) attributable to the period during which the member of the EAG and the computing member are both members of the EAG, and (2) taken into account in a tax year that begins after the effective date of section 199 and ends with or within the tax year of the computing member for which the QPAD is computed.

#### **B. Application to Passthrough Entities**

Section 199(d)(1) provides that, in the case of a partnership, S corporation, estate, or other passthrough entity, the QPAD is determined at the partner, shareholder, or similar level. The notice provides that the IRS and Treasury believe that Congress intended section 199 to be applied in a manner consistent with the economic arrangement of the owners of a passthrough entity. An owner of a passthrough entity will calculate the amount of its QPAD by taking into account its distributive or proportionate share of the items (including items of income, gain, loss, deduction, CGS allocated to such items of income, and gross receipts that are included in such items of income) allocated or attributable, in accordance with section 4.06 of the notice, to the passthrough entity's activities described in section 199(c)(4) (qualified production activities), provided those items are not otherwise disallowed by the code. The owner of the passthrough entity will aggregate its items of income or expense (including W-2 wages) allocated or attributable to the passthrough entity's qualified production activities, including those expenses incurred by the owner of the passthrough entity directly that are allocated to the passthrough entity's qualified production activities, and the owner's items of income or expense (including W-2 wages) allocated or attributable to its other qualified production activities.

#### **Observations**

The notice does not explicitly provide that the character of an item as a production item passes through to the

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partner or shareholder. Nevertheless, under the approach taken by Treasury, it appears that character passes through to the partner or shareholder. The notice does not explicitly provide how to determine when a partnership's activities are qualifying activities. It is clear that a partnership's items are production items if the partnership's activities are production activities; but it is not clear whether the partnership's nonproduction activities can be combined with someone else's activities to add up to a production activity.

1. **Treatment of expenses.** Each partner or shareholder must take into account its distributive share of expenses allocated to the qualified production activities of the partnership or S corporation, regardless of whether the partnership or S corporation otherwise has taxable income. To the extent there are disallowed losses or deductions because of a lack of basis, the at-risk rules, or the passive activity rules, a proportionate share of the losses or deductions that reflect expenses allocated to qualified production activities are suspended as well. Subsequently, when those losses or deductions are "freed up," the partner or shareholder will take into account (in the year they are freed up) its proportionate share of production activity losses or deductions previously suspended.
2. **Special allocations.** A partnership may specially allocate items of income, gain, loss, or deduction allocated or attributable to the partnership's qualified production activities, subject to the normal section 704(b) rules, including the rules for determining substantial economic effect.

**Observations**

Careful consideration must be given to the substantial economic effect requirement and the economic and tax risks associated with a special allocation of production activity related items by a partnership.

3. **W-2 limitation.** An owner's share of W-2 wages of a passthrough entity is the lesser of the owner's allocable

share of the passthrough entity's W-2 wages or two times the applicable percentage of the owner's QPAI computed taking into account only the items of the passthrough entity allocated to the owner for the tax year.

**Observations**

The special limitation to two times the applicable percentage of the partner or shareholder's QPAI is based only on items allocated from the entity in question. A partner or shareholder who is not allocated any positive QPAI from the entity may not take into account any W-2 wages of the entity for purposes of computing the QPAD.

4. **Gain or loss from disposition of interests.** Because the sale of an interest in a passthrough entity does not reflect the realization of QPAI by that entity, QPAI generally does not include gain or loss recognized on the sale, exchange, or other disposition of an interest in the entity. Nevertheless, some sales or exchanges of a partnership interest (or distributions treated as a sale or exchange) under section 751 might give rise to an item of QPAI being taken into account for purposes of computing the QPAD. It is not clear under the notice how to determine when items of QPAI are generated when section 751 applies.

5. **Effective date.** The notice provides that section 199 applies only to tax years of passthrough entities that begin on or after January 1, 2005.

**Observations**

It is important to note that this effective date can cause a partner with a different tax year than the partnership's tax year to lose a portion of that partner's QPAD. While a January 1, 2005, effective date is easier to administer, it is not consistent with the aggregate approach.

6. **Additional K-1 reporting requirements.** The notice states that Treasury intends to provide rules relating to information reporting by passthrough entities in future guidance.

**Observations**

Overall, Treasury has generally taken an aggregate approach to section 199. Essentially, each partner or shareholder will separately take into account its distributive or proportionate share of items of income, gain, loss, or deduction (including gross receipts, costs of goods sold, and W-2 wages) allocable or attributable to qualified production activities performed by the partnership or S corporation. These items will then be aggregated at the partner or shareholder level with other qualifying production activity income and items for the purpose of computing the allowable deduction under section 199.

**Example: Application of Section 199 to Passthrough Entities.** Assume A and B are partners in AB General and AB Limited. AB General and AB Limited both operate wholesale bakeries that sell baked goods to local grocers and restaurants. A is a 50 percent general partner in both AB General and AB Limited. B is a 50 percent general partner in AB General and a 50 percent limited partner in AB Limited. The parties have agreed to share profits and losses equally.

In years 1 and 2, the partnerships have the following activity, shown in the table on the following page, all of which is QPAI:

|                                 | AB Limited    |               | AB General  |             |
|---------------------------------|---------------|---------------|-------------|-------------|
|                                 | Year 1        | Year 2        | Year 1      | Year 2      |
| DPGR                            | \$1,000,000   | \$1,500,000   | \$1,000,000 | \$1,000,000 |
| Allocated and Apportioned Costs | (\$1,200,000) | (\$1,250,000) | (\$500,000) | (\$500,000) |
| Income/Loss                     | (\$200,000)   | \$250,000     | \$500,000   | \$500,000   |
| W-2 Wages                       | \$100,000     | \$100,000     | \$40,000    | \$40,000    |
| A&B's Distributive Share (50%)  |               |               |             |             |
| QPAI                            | (\$100,000)   | \$125,000     | \$250,000   | \$250,000   |
| Lesser of:                      |               |               |             |             |
| W-2 wages                       | \$50,000      | \$50,000      | \$20,000    | \$20,000    |
| 2X Limitation                   | \$0           | \$7,500       | \$15,000    | \$15,000    |
| W-2 wages                       | 0*            | \$7,500       | \$15,000    | \$15,000    |

\*Each partner's share of W-2 wages from the partnerships is the lesser of the partners' allocable share of the partnership W-2 wages, or two times the applicable percentage of the owner's QPAI taking into account only the items of the partnership allocated to the partner, determined at the partner level (2 x 3% x QPAI). If the distributive share of QPAI allocated to the partner for the tax year is not greater than zero, the partner may not take into account any W-2 wages of the partnership for purposes of computing the wage limitation at the partner level.

Once the partnership has determined each partner's distributive share of all items, each owner then computes its deduction by taking into account the items allocated or attributable to the partnership's qualified production activities, provided recognition of those items is not otherwise disallowed by the code.

The partner-level computations are as follows:

| Partner A              | Year 1      | Year 2    |
|------------------------|-------------|-----------|
| AB Limited QPAI        | (\$100,000) | \$125,000 |
| AB General QPAI        | \$250,000   | \$250,000 |
| QPAI                   | \$150,000   | \$375,000 |
| x 3%                   | \$4,500     | \$11,250  |
| AB Limited W-2 wages   | \$0         | \$7,500   |
| AB General W-2 wages   | \$15,000    | \$15,000  |
| Total W-2 wages        | \$15,000    | \$22,500  |
| x 50% = W-2 Limitation | \$7,500     | \$11,250  |
| Allowable QPAD         | \$1,500     | \$11,250  |

Because B's loss for year 1 is disallowed as a passive activity loss under section 469, the computation of B's deduction is as follows:

| Partner B              | Year 1    | Year 2    |
|------------------------|-----------|-----------|
| AB Limited QPAI        | \$0       | \$25,000  |
| AB General QPAI        | \$250,000 | \$250,000 |
| QPAI                   | \$250,000 | \$275,000 |
| x 3%                   | \$7,500   | \$8,250   |
| AB Limited W-2 wages   | \$0       | \$7,500   |
| AB General W-2 wages   | \$15,000  | \$15,000  |
| Total W-2 wages        | \$15,000  | \$22,500  |
| x 50% = W-2 Limitation | \$7,500   | \$11,250  |
| Allowable QPAD         | \$7,500   | \$8,250   |

Note that the \$100,000 passive activity loss from the limited partnership is suspended in year 1, but is taken into account in year 2. That decreases partner B's recognition of QPAI accordingly to \$25,000 (\$125,000 - \$100,000).

### IX. Five Steps Taxpayers Should Take

The QPAD offers a significant tax benefit for a wide range of taxpayers. Now that Treasury has provided this first round of guidance, what should taxpayers do next? Below are five steps taxpayers should consider immediately to help them appropriately respond to the new law.

1. Understand what activities qualify for the QPAD. While the notice provides answers to many of the initial questions arising from the passage of section 199, taxpayers still should conduct a thorough analysis of their activities to determine exactly what qualifies for the QPAD. Most importantly, taxpayers should not assume

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that they do not qualify because they are not a "traditional" manufacturer. The explanation accompanying the notice specifically refers to Congress's intent to make the new deduction available to taxpayers undertaking a wide variety of production activities. In line with that intent, the notice broadly defines the meaning of "manufactured, produced, grown, or extracted." Taxpayers should thoroughly familiarize themselves with all areas to which the "manufactured, produced, grown, or extracted" requirement extends and should conduct a detailed analysis of their business operations to identify all activities that potentially qualify.

2. Put in place processes for gathering the requisite data to calculate QPAI. Taxpayers who can identify qualifying activities need to accumulate the revenue and expense detail necessary to calculate QPAI. In many instances, bifurcating financial detail between qualifying and nonqualifying activities will require development of new processes and procedures within the tax department, as well as in other areas of the organization, such as the accounting and information technology departments.

3. Develop methods for data analysis. Additional work may be required to apply the section 861 source rules within a wholly domestic context. Taxpayers that have never previously performed a section 861 allocation — many utilities fall into that category — will need to develop a method. For taxpayers with previous section

861 experience, the interaction between the new QPAI calculation and the current foreign tax credit or EIT calculation will need to be fully considered.

4. Accumulate appropriate information to substantiate amount claimed. Taxpayers should ensure that they accumulate and preserve the information necessary to substantiate the final amount claimed. For purely financial data, as stated above, taxpayers will probably need to work with their IT department or outside consultant to identify and accumulate the relevant transactional detail available within the organization. When qualitative analyses are required, taxpayers should document the facts and conclusions necessary to justify and sustain the positions taken.

5. Consult with a qualified professional tax adviser. Even taxpayers who are certain that their activities qualify and who believe that they possess the requisite information to substantiate their QPAI may benefit from consulting with their tax advisers. While section 199 may be refreshingly short, the notice is not. There are many nuances in the statute and the notice: Some are addressed in the notice; some are addressed but not yet resolved; others have not been addressed at all. A qualified professional tax adviser may be able to assist a taxpayer not only in complying with section 199 but also in sustaining additional benefits.

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Remember, people pay attention to what appears in *Tax Notes*.

## IRC 199 QPAI Deduction

4/4/2005

### Primer: IRC 199 Qualified Production Activity Income (QPAI)

#### The new federal law:

- Beginning in 2005, taxpayers may exclude a portion of their qualified production activity income (QPAI). QPAI includes income from extraction, production, and manufacturing in the United States.
- The affected industries of particular interest to Alaska include oil and gas production, refining and marketing, construction, fishing and fish processing, and mining.
- The 2005 deduction is 3 percent of QPAI increasing to 6 percent in 2007 and 9 percent for 2010 and thereafter.

#### Application and impact in Alaska:

- Alaska automatically adopts the QPAI deduction unless it enacts legislation to decouple from federal law.
- The impact to Alaska is more dramatic compared to most other states due to the dominance of natural resources in our tax base.
- Alaska cannot restrict the deduction to Alaska QPAI or even US QPAI. Corporations are allowed a deduction for world-wide QPAI to the extent the income or loss from the activity is included in the calculation of taxable income.
- FY04 corporate tax receipts would have been \$24.7 to \$27.4 million less under the fully implemented QPAI deduction of 9 percent.
- We project revenue losses during the ten year period beginning in FY05, accounting for the phase-in, of more than \$100 million.

#### DOR observations:

- The federal tax and economic policy goals of the QPAI deduction are not achieved at the state level.
- The burden of administering the QPAI deduction will result in additional costs and/or revenue losses in addition to the cost of the exclusion itself.

ceh/mag  
4/4/2005

Tax Division  
Department of Revenue

4/5/05  
SB 151

IRC 199 QPAI Deduction  
4/4/2005

Projected State Revenue Loss from QPAI Deduction  
(\$ Millions)

|         | High            | Low            | High    | Low     |
|---------|-----------------|----------------|---------|---------|
| FY 2005 | (5.40)          | (4.85)         |         |         |
| FY 2006 | (8.65)          | (7.81)         | (23.92) | (21.63) |
| FY 2007 | (9.87)          | (8.97)         |         |         |
| FY 2008 | (11.16)         | (10.11)        |         |         |
| FY 2009 | (11.10)         | (10.08)        | (32.75) | (29.69) |
| FY 2010 | (10.49)         | (9.50)         |         |         |
| FY 2011 | (15.71)         | (14.20)        |         |         |
| FY 2012 | (16.12)         | (14.56)        | (48.17) | (43.56) |
| FY 2013 | (16.34)         | (14.80)        |         |         |
|         |                 |                |         |         |
| FY05-13 | <b>(104.84)</b> | <b>(94.88)</b> |         |         |

Projections reflect phase-in deduction levels of 3% for the 2005-2006 tax years, 6% for 2007 – 2009, and 9% thereafter, applied to forecasted corporate income tax receipts.

IRC 199 QPAI Deduction  
4/4/2005

**Status of QPAI in Other States**

| Decoupled from Federal QPAI Deduction   | Decoupling Legislation Pending                                     | Conform to Federal QPAI Deduction   | Conforming Legislation Pending |
|---|--|---|--------------------------------|
| Automatically under existing law:<br>Minnesota<br>Arkansas<br>California<br><br>Legislation enacted:<br>Massachusetts | Montana<br>New Jersey<br>Maryland<br>North Dakota<br>West Virginia | Automatically under existing law:<br>Alaska<br>Louisiana<br>Tennessee<br>New York<br>Oklahoma<br>Missouri<br>Utah<br>Illinois<br>Delaware<br><br>Legislation enacted:<br>Ohio | Indiana<br>Iowa<br>Virginia    |

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SB 151

IRC 199 QPAI Deduction  
3/21/2005

**Primer: IRC 199  
Qualified Production Activity Income (QPAI)**

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Application and impact in Alaska:

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- The burden of administering the QPAI deduction will result in additional costs and/or revenue losses in addition to the cost of the exclusion itself.

ceh/mag  
3/21/2005

Tax Division  
Department of Revenue

IRC 199 QPAI Deduction  
3/21/2005

Application of the QPAI Deduction in Alaska

|   |   |   | w/ QPAI   | w/o QPAI     |
|---|---|---|---|--------------|
| 1 | Determine Alaska QPAI                       | Determine world-wide or waters-edge QPAI:<br><ul style="list-style-type: none"> <li>- QPAI of the combined group</li> <li>- No geographical restrictions, include foreign activities as well those in Alaska and other states</li> <li>- Apportion to Alaska</li> </ul> | \$48,000,000                                      |              |
| 2 | Determine Alaska taxable income before QPAI | Taxable income under prior law  | \$50,000,000                                      |              |
| 3 | Determine Preliminary QPAI Deduction        | Apply federal deduction rate to lesser of Alaska QPAI or taxable income before QPAI   | 9% of<br>\$48,000,000<br>\$4,320,000              |              |
| 4 | Wage Limitation                             | Add W-2 wages plus comparable wage measure for foreign wages of the combined group and multiply total times apportionment factor, times 50%   | \$6,000,000                                       |              |
| 5 | QPAI Deduction                              | Lesser of Preliminary QPAI deduction or Wage Limitation   | \$4,320,000                                       |              |
| 6 | Taxable income                              | Subtract QPAI from Alaska taxable income before QPAI  | \$50,000,000 –<br>\$4,320,000<br>\$45,680,000     | \$50,000,000 |
| 7 | Tax Before Credits                          |   | \$4,289,960<br>8.65% reduction<br>in this example | \$4,696,040  |
| 8 | Credits                                     |   | \$200,000   | \$200,000    |
| 9 | Tax   |   | \$4,089,960<br>9% reduction in<br>this example    | \$4,496,040  |

IRC 199 QPAI Deduction  
3/21/2005

Projected State Revenue Loss from QPAI Deduction  
(\$ Millions)

|                | High            | Low            | High     | Low     |
|----------------|-----------------|----------------|----------|---------|
| FY 2005        | (5.40)          | (4.85)         | FY05-07  |         |
| FY 2006        | (8.65)          | (7.81)         | (23.92)  | (21.63) |
| FY 2007        | (9.87)          | (8.97)         |          |         |
| FY 2008        | (11.16)         | (10.11)        | FY08-010 |         |
| FY 2009        | (11.10)         | (10.08)        | (32.75)  | (29.69) |
| FY 2010        | (10.49)         | (9.50)         |          |         |
| FY 2011        | (15.71)         | (14.20)        | FY11-13  |         |
| FY 2012        | (16.12)         | (14.56)        | (48.17)  | (43.56) |
| FY 2013        | (16.34)         | (14.80)        |          |         |
| <b>FY05-13</b> | <b>(104.84)</b> | <b>(94.88)</b> |          |         |

Projections reflect phase-in deduction levels of 3% for the 2005-2006 tax years, 6% for 2007 – 2009, and 9% thereafter, applied to forecasted corporate income tax receipts.

IRC 199 QPAI Deduction  
3/21/2005

Status of QPAI in Other States

| Decoupled from Federal QPAI Deduction  | Decoupling Legislation Pending  | Conform to Federal QPAI Deduction  | Conforming Legislation Pending       |
|--|---|--|--------------------------------------|
| <p>Automatically under existing law:<br/>Minnesota<br/>Arkansas<br/>California</p> <p>Legislation enacted:<br/>Massachusetts</p> | <p>Montana<br/>New Jersey<br/>Maryland<br/>North Dakota<br/>West Virginia</p> | <p>Automatically under existing law:<br/>Alaska<br/>Louisiana<br/>Tennessee<br/>New York<br/>Oklahoma<br/>Missouri<br/>Utah<br/>Illinois<br/>Delaware</p> <p>Legislation enacted:<br/>Ohio</p> | <p>Indiana<br/>Iowa<br/>Virginia</p> |

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## Alaska Oil and Gas Association

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121 W. Fireweed Lane, Suite 207  
Anchorage, Alaska 99503-2035  
Phone: (907)272-1481 Fax: (907)279-8114

**Testimony  
of the  
Alaska Oil and Gas Association  
to the  
Senate Finance Committee  
Regarding SB 151**

**April 18, 2005**

Good morning. My name is Tom Williams, and I am Chair of the Tax Committee of the Alaska Oil & Gas Association ("AOGA"). AOGA is a private trade association whose 18 members companies account for a majority of the oil and gas exploration, development, production, transportation, refining and marketing activities in Alaska. On behalf of AOGA and its members, I thank you for this opportunity to testify on Senate Bill 151.

AOGA opposes this legislation for two reasons. First, the justification for it has been misstated to you and its fiscal impacts have been significantly overstated. Second, the Bill represents yet another tax increase on the oil industry from this Administration.

To explain our reasons for opposing the Bill, let me first provide you briefly with some background. Last year Congress passed the federal Jobs Act creating, among other things, a tax incentive to improve the competitiveness of manufacturing in the United States, which currently is disadvantaged relative to the rest of the world because national income tax rates on such activity overseas are generally lower. This tax incentive takes the form of a new deduction that is equal to a percentage of a taxpayer's "qualified production activity income" ("QPA Income") from manufacturing activity occurring in the United States. The tax deduction equals 3% of this QPA Income initially; it increases to 6% in 2007 and reaches its full size of 9% beginning in 2010. In order to make this work as an incentive to create and keep jobs in the United States, Congress specifically limited QPA Income to income from domestic, U.S.-only activity.

Alaska's state income tax automatically adopts sections 1 – 1399 and 6001 – 7872 of the Internal Revenue Code, including new sections within these number ranges as they are enacted, amendments as they are made to existing sections, and even repeals of any of these sections in the federal Code. Alaska picks up these federal changes unless the Legislature enacts a law to prevent such a federal change from taking effect, or modify its effect, for state purposes. The new deduction for QPA Income is in Section 199 of the Internal Revenue Code and hence has been picked up for state purposes. Senate Bill 151 proposes to undo this automatic adoption of Section 199 and keep it from taking effect for state income-tax purposes.

In the fiscal note for this legislation, the Department of Revenue ("DOR") claims that letting Section 199 take effect for Alaska purposes would cost the State between \$94.88 million and \$104.84 million in total over the FY05 – FY13 period. Further, DOR's fiscal note states it could cost more than half a million dollars a year for DOR to administer Section 199 if it takes effect for state purposes.

Both of these estimates are, in AOGA's opinion, severely overstated because of a faulty premise in DOR's analysis. This premise is stated in the fiscal note as follows:

In order to avoid impermissible discrimination against economic activity outside of the state, taxpayers will be allowed the QPA[ Income] deduction on their Alaskan return for all production profits whether the activity occurred in Alaska, another state, or in a foreign country. Production activity conducted in-state, domestic out of state, or in a foreign country will be awarded an equal deduction.

In other words, in assessing the state revenue impact of letting Section 199 take effect, DOR looked at potential "production activity income" everywhere in the world. It did not look just at "qualified" production activity income as defined by Congress, which is only that income which comes from production activity inside the United States.

Despite what DOR asserts to the contrary in its fiscal note, when Alaska passively adopts a limited federal deduction, it does not legally or logically follow from this fact that DOR must, under the Foreign Commerce Clause of the U.S. Constitution, completely remove the limitation in the course of administering the deduction for state tax purposes. There is ample precedent where a geographically limited federal provision remains limited in precisely the same way when it is applied under the Alaska income tax. For instance, expenditures for enhanced oil recovery ("EOR") give rise to a federal tax credit that Alaska also allows, and the federal credit is limited to expenditures for EOR projects in the United States — in administering the EOR credit for state purposes, DOR does not impute a hypothetical credit for EOR projects outside the United States "[i]n order to avoid impermissible discrimination against economic activity outside of the state[.]" instead, DOR uses the same domestic territorial limitation as the federal credit has. We do not see how the domestic territorial limitation in the new QPA Income deduction would be any different from the one for EOR in terms of its potential for "impermissible discrimination." In other words, since DOR isn't applying the EOR credit on a worldwide basis, it is inconsistent for DOR to say it must apply the QPA Income deduction on a worldwide basis.

Because of its faulty premise about how broadly the QPA Income deduction must be applied for state purposes, DOR's estimated revenue impacts are overstated by at least a factor of two or three or more, depending on how much QPA-ish income it foresaw from non-U.S. production activities. Similarly, the estimated administrative cost of half a million dollars a year is entirely a result of this same faulty assumption. The IRS will audit taxpayers' QPA Income from activities in the U.S., and there will be nothing left for DOR to audit and enforce. The half a million dollars a year should, in other words, disappear.

AOGA also disagrees with DOR's conclusion in the fiscal note that the anticipated beneficial effects of the QPA Income deduction at the federal level "cannot be replicated at the state level." At least with respect to oil and gas, the two principal regions of qualified production activity in the United States are the deep-water Gulf of Mexico and Alaska. With only two "hot spots" for the action to occur in, it seems likely that Alaska would be ahead of the game when the incentive works in attracting production activity to the U.S. Given DOR's contrary conclusion about these benefits for Alaska, it seems improbable that DOR made any serious attempt to estimate and include the increases in state tax revenues from the production activities in Alaska that this tax incentive would help attract to this state.

Thus, both on policy grounds as well as potential fiscal impacts, the justification that DOR has given for this legislation has been both overstated and misstated.

This brings me to AOGA's second reason for opposing this legislation: it represents yet another tax increase on the oil industry from this Administration. It is a tax increase because Section 199 of the Internal Revenue Code was automatically adopted for state purposes as of January first of this year, when it took effect for federal purposes. Section 199 is, in other words, already the status quo. SB 151 proposes to change this status quo by undoing the adoption of Section 199, and in doing so it will raise corporate income taxes for our industry and every other industry in the state having "qualified production activity."

DOR's just-released Spring 2005 Revenue Sources Book predicts future state oil and gas revenues through FY2015 based on assumptions that tens of billions of dollars of new investments will be made during that time which will hold oil production at the projected levels and keep it from declining as it otherwise will. Fortunately for Alaska, the opportunities for making these investments, and the possibility that they will indeed result in the production being hoped for, are not some wild pipe dream, but a plausible expectation. The key to fulfilling this bright expectation lies in winning the competition for funding so that the potential Alaskan investments will become actual investments.

Raising taxes does not make Alaska's investment opportunities more competitive. It makes them less competitive.

Some have said that, with today's high oil prices, Alaska can and should raise its oil taxes — the producers can afford to pay a larger share out of this "windfall," they say. This reasoning misses the real issues here. From the industry's perspective, the question is not about how much it can afford to pay to Alaska, but how much it can afford to invest in Alaska relative to opportunities elsewhere. Fifty-dollar oil is not \$50 just for Alaskan oil, but for all oil wherever produced. High oil prices do not change the fact that Alaska is among the most expensive places in the world to operate and produce oil.

From the State's perspective as well, the question is not so simplistic as to be only about what the industry might be able to pay. There is a trade-off between, on the one hand, taking a larger share now and having less available to be shared in the future because some investments cease to be competitive enough to win funding, and on the other hand, taking the same or per-

haps even a more modest share and having more available to be shared in the future because more investments become competitive enough to win funding. Or to put it another way, which gives the State more — taking a wider slice out of a smaller pie, or a narrower slice out of a larger pie? and what is the optimum width for that slice so that it has the most fiscal “weight”?

Some simplistically believe that \$50 oil will justify any and all of the investment opportunities that industry has in Alaska, despite raising taxes as proposed in this Bill or raising them by lumping satellite fields with their parent field for ELF purposes. Such reasoning apparently led DOR and DNR to advise the Governor to introduce this Bill, and to make the Prudhoe Bay ELF decision. The Governor was, no doubt, assured in both situations that neither action would actually change investment decisions.

The advice that the Governor received about the ELF decision has already been proven wrong. The Orion field in the western region of the Prudhoe Bay Unit, for example, is a development that industry has been diligently pursuing to help stem the decline of North Slope production. The producers have already stated that, because of the tax increase under that decision, they will not be able to proceed with the planned expansion of the Orion field as it is currently proposed. This expansion would have been a \$650 million project to develop viscous oil in the Prudhoe Bay Unit. An associated casualty is the I-100 Well for viscous oil development that was on this year's drilling schedule for Prudhoe Bay, but now has been removed and indefinitely deferred.

The advice that the Governor has been given about this Bill is also wrong, for the same reasons. Because it has not become law, there is no hard, empirical evidence to offer you to show that this Bill is ill-advised for the State. Fortunately, however, this same circumstance means it is not too late for you, the Legislature, to avoid repeating the mistake of the Governor's advisors. You are in the position of being able to refrain from acting, and you should.

AOGA has long said, and we say again now, any change to Alaska's existing fiscal regime for our industry needs to be carefully evaluated for its impacts on each of the different kinds of investments there are for getting more oil produced. Otherwise, there is a substantial risk that the anticipated benefits from such a change could end up being more than offset by unanticipated negative effects of that change on other kinds of oil investments.

We believe that raising oil taxes now, as SB 151 would do, will send precisely the wrong message to the industry about making the investments that Alaska so desperately needs and is counting on for its own fiscal future. Accordingly, AOGA opposes this Bill and respectfully urges that you oppose it too.

This concludes our testimony. Thank you again for the opportunity to appear before you today and testify.



SB 151

FRANK H. MURKOWSKI  
GOVERNOR  
GOVERNOR@GOV.STATE.AK.US

P.O. Box 110001  
JUNEAU, ALASKA 99811-0001  
(907) 465-3500  
FAX (907) 465-3532  
WWW.GOV.STATE.AK.US

STATE OF ALASKA  
OFFICE OF THE GOVERNOR  
JUNEAU  
March 22, 2005

The Honorable Ben Stevens  
President of the Senate  
Alaska State Legislature  
State Capitol, Room 111  
Juneau, AK 99801-1182

Dear President Stevens:

Under the authority of art. III, sec. 18, of the Alaska Constitution, I am transmitting a bill excepting from the Alaska Net Income Tax Act the federal deduction regarding income attributable to certain domestic production activities.

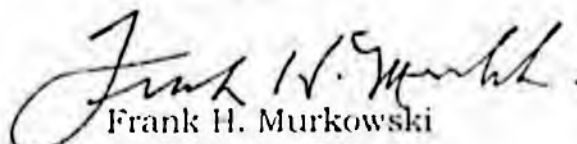
Last year Congress passed legislation (American Jobs Creation Act of 2004) that created a new federal tax deduction for corporations regarding income attributable to certain domestic production activities. Alaska tax law automatically adopts such federal tax deductions unless the Legislature explicitly excepts to them (AS 43.20.021(a)). Because of Alaska's unique reliance on natural resource development, this particular deduction will have major impacts on the state's revenue flow. The Department of Revenue estimates that this federal tax deduction could cut \$100 million from state corporate income tax revenue over the next decade.

With the passage of this legislation, Alaska's corporate income tax structure will stay the same as it is under the current regime. This will provide continued stability and tax certainty to corporations operating in the State of Alaska.

Several other states also have introduced legislation to "de-couple" their tax code from this new federal provision, including Montana, New Jersey, Maryland, North Dakota and West Virginia. Massachusetts has enacted such legislation.

I urge your prompt and favorable action on this measure.

Sincerely yours,

  
Frank H. Murkowski  
Governor

Enclosure

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