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Select State Tax Implications Of Conformity To Qualified Production Activity Income Deduction

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State Tax Conformity with IRC § 199

In 2004, the federal government enacted the American Jobs Creation Act (PL 108-357) which created a new manufacturing deduction (IRC § 199) for a specified portion of "Qualified Production Activity Income" (QPAI). In general, IRC § 199 provides a deduction equal to 3% (increasing to 9% when fully phased in 2010) of the lesser of: (1) taxable income derived from a qualified production activity; or (2) taxable income, for the tax year. The deduction is limited, however, to fifty percent of the W-2 wages paid by the taxpayer during the tax year.

Since in most states federal taxable income serves as the starting point for the calculation of corporate income tax, those states conforming to the federal legislation providing the new manufacturing deduction will experience a reduction in tax revenue. With respect to federal tax conformity, the states fall into two categories: (1) automatic conformity; or (2) fixed or selective conformity.

In states that automatically conform to the most current version of the Internal Revenue Code, the state must enact legislation to decouple from the IRC § 199 deduction. Fixed or selective conformity states generally will not conform to the IRC § 199 deduction unless the state affirmatively enacts legislation conforming to the new deduction. According to the Federation of Tax Administrators, it appears that 27 states will, or likely will, conform to the IRC § 199 deduction and 19 states have apparently decided not to conform.[1]

States conforming to, or likely to conform to, the deduction include Alabama, Alaska, Arizona, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Michigan, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Oregon, Pennsylvania, Utah, Vermont, Virginia, and Wisconsin.

[1] *See* FTA Bulletin, B-25/05 (June 7, 2005).

States not conforming to the deduction include Arkansas, California, Georgia, Hawaii, Indiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, New Hampshire, New Jersey, North Carolina, North Dakota, Rhode Island, South Carolina, Tennessee, Texas, and West Virginia. Likewise, the District of Columbia is not conforming to the provision.

Notice 2005-14

On January 19, 2005, Treasury and the Internal Revenue Service issued Notice 2005-14, which provides interim guidance regarding the computation of the IRC § 199 production deduction. The notice also provides rules in applying IRC § 199 to pass-through entities, and provides definitions and rules for determining the expanded affiliated group (EAG) and allocating the IRC § 199 deduction among members of the EAG. Since these rules apply for purposes of computing the deduction and do not fall within the federal consolidated return regulations, to the extent a state uses federal taxable income as the starting point for computing state taxable income, the notice applies at the state level.

Under IRC § 199, all members of an EAG are treated as a single corporation and the deduction is allocated among the members of the EAG in proportion to each member's respective amount of QPAI. Notice 2005-14 provides that a member's QPAI is the member's domestic production gross receipts (DPGR) less the sum of the cost of goods sold (COS) allocable to the receipts and other costs required to be allocated to DPGR. For purposes of determining whether gross receipts are DPGR, each member of an EAG is treated as conducting the activities conducted by each other member of the EAG. A member's QPAI may be positive or negative and the member's taxable income or loss and QPAI will be determined by reference to the member's methods of accounting.

Further, Notice 2005-14 provides that the EAG's IRC § 199 deduction is allocated among the EAG members in proportion to each member's QPAI, regardless of whether: (1) the EAG member has taxable income or loss for the tax year, or (2) the EAG member has W-2 wages for the tax year. Under the notice, members of a consolidated group are treated as a single member of the EAG for both purposes of determining the EAG's IRC § 199 deduction and allocating the deduction among the members. Thus, if an EAG includes corporations that are members of a consolidated group and corporations that are not members of a consolidated group, in determining the taxable income limitation of the EAG, the consolidated taxable income of the consolidated group, not the separate taxable income of the members of the consolidated group, is taken into account. After an EAG's deduction is allocated to a consolidated group, the deduction is re-allocated within the group based on the general allocation rules.

Select State Tax Implications of IRC § 199 and Notice 2005-14

Since many states require the calculation of separate company taxable income, it is necessary to determine the amount of the IRC § 199 deduction allocated to each member of an expanded affiliated group and each member of a federal consolidated return group. Moreover, depending on a taxpayer's current corporate organizational structure, the IRC § 199 deduction may be shifted to an entity with a low state effective tax rate or, even worse, the organizational structure may result in a lower IRC § 199 deduction at the federal level.

Deduction Shift to Entity with Low Effective Tax Rate

Assume that P and D are members of an affiliated group filing a consolidated federal income tax return with P as the common parent. In addition, P owns 75% of M. As such, P, D and M are members of an EAG. M manufactures qualifying product for sale to P who in turn sells the finished goods to D. As noted above, activities of each member of an EAG are attributed to the other members of the EAG. Accordingly, each company is deemed to sell qualified production property and generate DPGR. To the extent DPGR exceeds COS and allocated expenses, QPAI results. The federal IRC § 199 deduction will be allocated to those members with positive QPAI based on relative QPAI.

Assume in the above example that P also owns R, a company that holds intellectual property and receives royalties from P and D for the use of that property. The royalty deduction is allocable to COS and reduces the QPAI of P and D. By itself, the licensing of intangible property does not result in QPAI for R. To the extent the royalty income is re-characterized as DPGR, R has QPAI and aggregate QPAI of the EAG is the same as it would be without the royalties. As such, a portion of the EAG's IRC § 199 deduction would be allocated to R, which most likely files state income tax returns in low tax or no tax jurisdictions.

Negative QPAI Impact and IRC § 199 Deduction Reduction

Corporate organizational structures containing partnerships may negatively impact the computation of the deduction. Partnerships are not part of an affiliated group under Section 1504 and, as such, are not part of the EAG. Consequently, the activity attribution rules do not apply and any intercompany charges by the partnership are outside the group. In addition, IRC § 199 has specific restrictions on the amount of wages that may be included by a partner in computing the limitation on the Section 199 deduction. W-2 wages passed through from a partnership are limited to twice the partner's share of partnership QPAI times the applicable deduction percentage.

Changing the facts in the original example, assume that M is a partnership owned 99.9% by P and 0.1% by D. Because M is a partnership, there is no attribution of M's activity to P or D. Consequently, the only QPAI is that of M.

Further, altering the facts of the above example, assume that R, the intellectual property company, is a partnership owned by P and M. The royalty deduction paid by P, M and D is allocable to COS and reduces QPAI of the payers. Because the partners will report the royalty income as distributive share from the partnership, there is no effect on consolidated taxable income. However, there likely is no recharacterization of the income and QPAI of the EAG is reduced as a result.

As reflected in the examples above, the calculation of QPAI and the IRC § 199 deduction directly impact taxable income for states in conformity with the current Internal Revenue Code. To the extent state tax planning impacts either the organizational structure or the intercompany transactions of an EAG, the IRC § 199 deduction must be carefully analyzed to avoid the negative implications described in the above examples. Furthermore, by revising the structure and/or intercompany relations it may be possible to allocate a greater portion of the deduction to EAG members with the highest effective state tax rates.■

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