



# JONES DAY COMMENTARY

## NEW SECTION 199 DEDUCTION AVAILABLE FOR 2005 BUT TAXPAYERS MUST WORK TO TAKE FULL ADVANTAGE OF THE SAVINGS

It is not often that Congress provides a new deduction to taxpayers, especially one with the potentially far-reaching impact of new Section 199. Unlike with many deductions, however, taxpayers cannot merely sit idly and wait until the preparation of their returns—at least not if they want to take full advantage of the available benefits. Instead, taxpayers should carefully consider how Section 199 might apply to them (which can be complicated, especially given the current uncertainties), and possibly implement new policies and procedures to optimize their bottom lines.

The American Jobs Creation Act of 2004 added Section 199 to the Internal Revenue Code. This new provision allows a deduction equal to a percentage (which increases from 3 percent for 2005 and 2006 to 6 percent for 2007 through 2009 and to 9 percent thereafter) of a taxpayer's qualified production activities income ("QPAI"). The provision contains numerous defined terms and tests, most of which are not intuitive.

### CURRENT GUIDANCE

In an effort to assist taxpayers and resolve open issues, the Treasury and the Internal Revenue Service (the "IRS") have issued much-needed guidance in time for the 2005 filing season. In January 2005, the IRS issued interim guidance for Section 199 in Notice 2005-14. As promised in that Notice, on October 20, 2005, the Treasury and the IRS issued extensive proposed regulations dealing with Section 199.

### NEW GUIDANCE FORTHCOMING

It is unclear when the proposed regulations will be issued in final form and whether the final regulations will be retroactive to taxable years beginning on or after January 1, 2005. Officials from the Treasury and the IRS have stated that they intend for the final regulations to be issued sometime in April 2006. There is no clear consensus, however, on what the effective

date of those final regulations will be. The ultimate effective date will depend upon when the regulations are issued in final form and the extent of any changes from the proposed regulations contained therein.

## TAXPAYER CHOICE—AT LEAST FOR NOW

Until the regulations are issued in final form with an effective date, taxpayers may rely on both the proposed regulations and Notice 2005-14. In fact, if the proposed regulations and Notice 2005-14 contain different rules, taxpayers may cherry-pick between the two sets of guidance.<sup>1</sup> However, if one of the two sets of guidance speaks to an issue and the other is silent, taxpayers must follow the single set of rules provided.

**Overview of New Deduction.** The proposed regulations—like Section 199 itself—are very detailed. Therefore, a quick review may be instructive before setting forth a few of the high points of the proposed regulations. (See the attached flowchart, “Do You Qualify for the Code § 199 Deduction?” for an introductory overview.) As mentioned above, Section 199 allows a deduction of a percentage of the taxpayer’s QPAI. That deduction is limited to the lesser of either (1) the taxpayer’s taxable income for the taxable year or (2) 50 percent of the W-2 wages paid by the taxpayer during the taxable year.

QPAI is defined as the domestic production gross receipts (“DPGR”) from the lease, rental, license, sale, exchange, or other disposition of certain property reduced by (1) the cost of goods sold allocable to those receipts, (2) other deductions, expenses, and losses directly allocable to such receipts, and (3) a ratable portion of deductions, expenses, and losses not directly allocable to such receipts or to other income. The type of property to which Section 199 applies includes (1) qualifying production property (“QPP”) that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States; (2) any qualified film; (3) electricity, natural gas, or potable water produced within the United States; (4) construction performed in the United States; or (5) engineering or architectural services performed in the

United States. A qualified film is one for which not less than 50 percent of the total compensation relating to production of the film is compensation for services performed in the United States by actors, production personnel, directors, and producers and that does not depict sexually explicit conduct. DPGR specifically excludes gross receipts from (1) the sale of food and beverages in a retail establishment and (2) the transmission or distribution of electricity, natural gas, or potable water. QPP is any item of tangible personal property, computer software, and certain sound recordings.

## ITEM AND SHRINK-BACK

One of the most important parts of the proposed regulations is the refinement of the definition of an item of QPP. This definition includes the so-called shrink-back rule. For purposes of Section 199, an “item” means the largest item offered to customers that qualifies for the deduction. In simpler terms, if the taxpayer’s product as a whole does not qualify under Section 199, the taxpayer must shrink its item back to the largest component of the product that does qualify. For example, if the taxpayer imports cars and installs upgraded stereo equipment and cellular telephone systems that the taxpayer manufactures in the United States, the car as a whole does not qualify as QPP. Instead, the taxpayer must shrink its item back to that which qualifies. As a result, only the gross receipts allocable to the upgraded stereo and telephone equipment qualify as DPGR.

What constitutes an item for purposes of construction and architectural or engineering services is determined on a case-by-case basis.

## DE MINIMIS SAFE HARBOR

The proposed regulations provide a safe harbor from having to allocate gross receipts between those that qualify as DPGR and those that do not. If less than 5 percent of the total gross receipts from an item do not qualify as DPGR, then

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1. Retroactive changes to Section 199 contained in the Gulf Opportunity Zone Act of 2005 (Pub. L. No. 109-135, \_\_\_\_ Stat. \_\_\_\_), which was signed into law on December 21, 2005, trump some of the pro-taxpayer provisions contained in the Notice. The proposed regulations incorporate the technical corrections enacted in the Gulf Opportunity Zone Act of 2005.

the taxpayer may treat all receipts from such item as DPGR. This safe harbor can apply to gross receipts that do not qualify because the receipts are for services or for non-QPP.

## EMBEDDED SERVICES

Certain services are sometimes included in the price that is charged for a product, including but not limited to delivery or installation. Those services would not alone qualify for the deduction under Section 199. Under the *de minimis* safe harbor, gross receipts attributable to embedded services may be considered DPGR if those receipts are less than 5 percent, the embedded services are not separately offered or bargained for, and the price for the embedded services portion is normally included in the price charged for the item.

## MISCELLANEOUS

The proposed regulations also provide detailed rules about:

- The allocation and apportionment of gross receipts and costs relating to those receipts.
- The allocation and apportionment of deductions.
- Intercompany transactions within a consolidated group.
- The calculation of, and what qualifies for, DPGR.
- The use of online software.
- Advertising revenues from printed materials.
- Section 263A conformity in determining when a taxpayer is considered to have produced an item.
- The allocation and apportionment of W-2 wages for purposes of the limitation on the deduction.
- The application of Section 199 to contract manufacturers and construction activities.
- The application of Section 199 to flow-through entities.
- The application of Section 199 to expanded affiliated groups.

## LAWYER CONTACTS

Members of Jones Day's Tax Practice have spent considerable time studying the provisions of the proposed regulations. If you would like additional information or assistance regarding any of the specific provisions of the proposed regulations, or advice regarding what you should do to take full advantage of the deduction, please feel free to contact either of the attorneys listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at [www.jonesday.com](http://www.jonesday.com).

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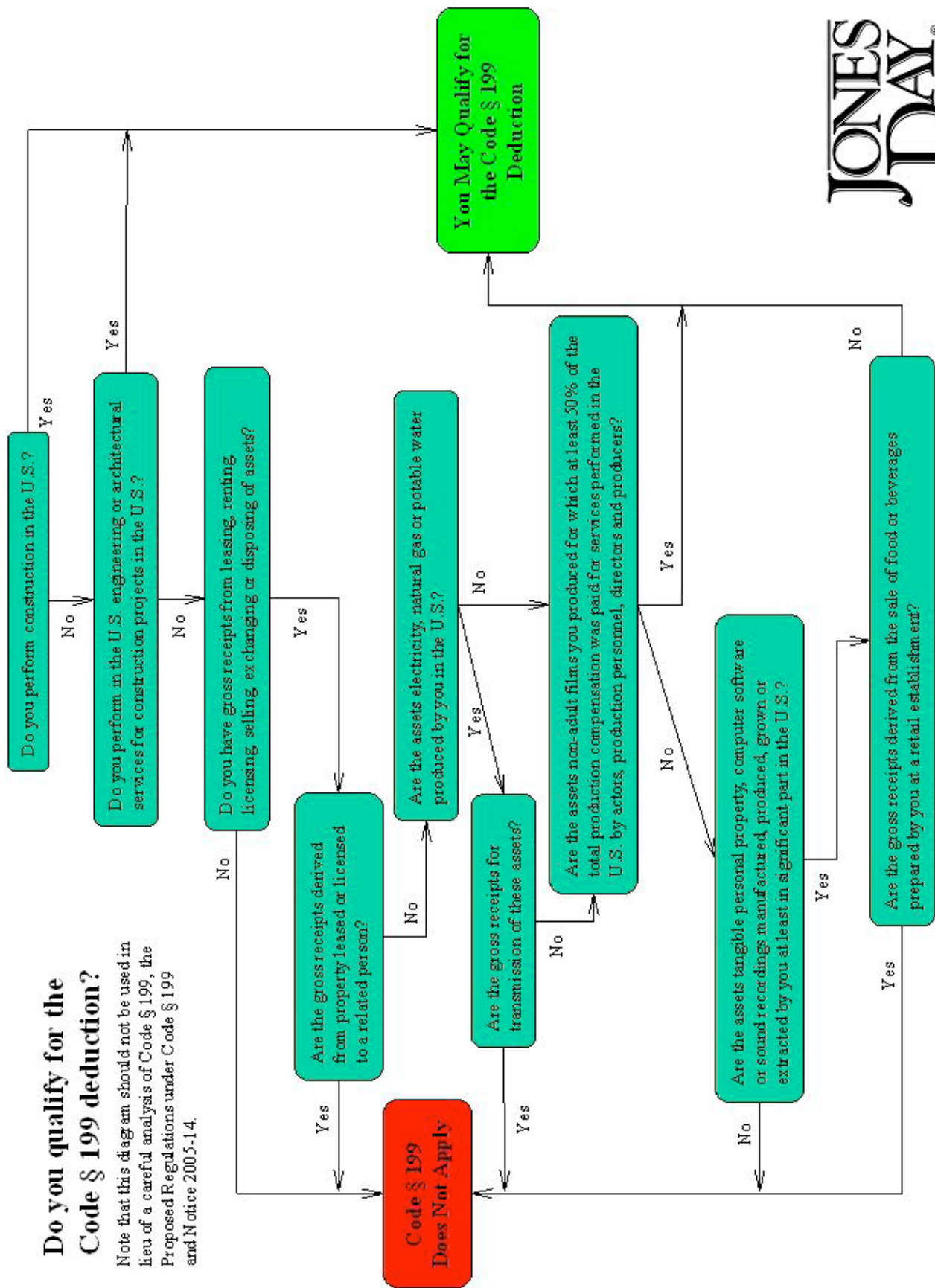
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## Do you qualify for the Code § 199 deduction?

Note that this diagram should not be used in lieu of a careful analysis of Code § 199, the Proposed Regulations under Code § 199 and Notice 2005-14.



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