M E M O R A N D U M

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"IRS offers interim guidance on manufacturing deduction"

The new domestic production activities deduction (a.k.a., the manufacturing deduction) has generated many unresolved questions. In the most recent version of Form 8903, Domestic Production Activities Deduction, the IRS estimated that over 17 million individuals and businesses will be affected and that each taxpayer will average 32 hours on the Form 8903.

The rules for the deduction appear to be a moving target. In this environment, tax strategies and advice must offer a degree of flexibility. This article raises some of the problems being encountered and proposes some solutions, either as a temporary patch or to guide more long-term actions.

Resources

Present guidance in dealing with the domestic production activities deduction comes in several forms:

- ❖ The Internal Revenue Code of 1986, as amended, Section 199, which runs for several pages, stating at its end that it is not enough, instruction that, "The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section."
- ❖ Notice 2205-14, provided minimal guidance from the IRS.
- ❖ NPRM REG-105847-05, issued in November 2005, proposed regulations that give taxpayers the option of being governed by it or Notice 2005-14 until final regulations are published.
- ❖ Final regulations are expected soon, although with the expectation that they probably will also need substantial revision sometime in the future.

Construction Activities

Calling the domestic production activities deduction by a shorter title was inevitable, but its abbreviated handle as "the manufacturing deduction" unfortunately has been misleading. The new business deduction includes many activities that are not manufacturing. They include not only de minimis services connected with the manufacturing of products, but also any activity relating to producing, growing or extracting, personal property, activities relating to construction, and engineering or architectural services relating to real property.

The construction industry is lobbying hard to expand the scope of what constitutes a construction activity to include selection, oversight and evaluation of contractors; materials selection, clearing and grading, as well as the lease of equipment to do so, should be included. While proposed regulations do say that construction of real property includes infrastructure such as road building, extension of that concept to other site work remains uncertain.

Finally, the proposed regulations seek to exclude materials markups changed by contractors. Contractors argue that separating labor from material costs is impractical and will be difficult to implement.

For the present, striving to keep careful records in construction projects should make it easier to maximize the inclusion of whatever costs are allowed under the final rules.

Computer software

The deduction is based on domestic production gross receipts, "DPGR", that include proceeds from the sale, lease, license, rental or disposition of products (qualified production property, "QPP") produced in the U.S. The regulations treat computer software as QPP produced if sold as part of tangible property such as a diskette or appliance. However, an increasing amount of software is being purchased through online downloads and software companies are questioning the distinction.

The IRS has given mixed signals on whether it will extend the deduction benefits to this Internet sales activity, worried that it would open up the floodgates of handling other service-related products. While the IRS is sorting this out, Internet sellers should attempt to keep track of which sales include downloads and which request shipment of a CD or diskette, to be ready for a negative decision from the IRS.

Item-by-item determination

The significant accounting costs for properly determining the amount of the deduction is a factor of major concern, especially among small businesses. Particularly in the early years of the deduction (3% for 2005 and 2006; 6% for 2007, 2008 and 2009; and 9% thereafter), when the deduction is limited to 3% of qualified production activities income "QPAI", the benefits may not be large enough to offset the costs for certain operations.

The deduction is based on a percentage of QPAI, computed by subtracting direct and indirect costs from DPRG on an item-by-item basis. An item is defined as property manufactured at least 20 percent within the U.S. and sold to customers. The IRS has inferred that to make certain that loss transactions are not disregarded, it will not accept determinations based on product lines, geographic location or other common factors.

So many businesses, especially small ones with limited resources, only account for product sales along product and geographic lines that the item-by-item approach will require a new system of accounting and recordkeeping for many of these businesses. While rumors persist that a safe harbor for mass-produced items by product line will be forthcoming, nothing official has been released as of June 2006.

Expenses for developing new accounting systems are also of concern to those who wish to use the "shrink-back" rule. Under that rule, the taxpayer must determine QPAI for the greatest component of property that meets the "made in U.S." standard, if the item itself does not qualify.

Rather than paying to develop new accounting systems to conform to existing regulations, at least a few businesses are sitting tight and hoping that a safe harbor rule will solve their particular issue with item-by-item reporting. While the deduction remains at 3%, the cost benefits appear to validate that interim strategy.

Embedded services

Valuation is a frequent problem in tax law and, is a significant issue for the manufacturing deduction. Valuing services that are included in the price of a product, such as a maintenance agreement on lease machinery, creates a significant problem in computing the deduction. The cost of embedded services must be excluded from the QPAI computation if the service is 5% or more of the value of the transaction. Is the service offered to sell the product or to make extra money off the product? Is the price of an after-market service contract the true value of the services component? While exceptions exist for warranties, training, delivery and installation if not separately priced, the Cost or keeping track of these separate components again must be considered in evaluating the tax benefit of the manufacturing deduction to determine its true value.

Passthroughs

For owners of passthrough entities, an aggregate approach under the regulations requires the entity to compute the income and deduction components of the deduction, then allocate the owner's share of each item. These amounts are reported on Schedule K-1. The owners then must aggregate the items from Schedule K-1 with their own separate income and deductions. As a result, the manufacturing deduction is computed at the partner level, based on the partner's share attributable to the partnership's trade or business.

Not being able to compute the deduction at the passthrough entity level promises to create enormous complexity and administrative costs for many Sub S shareholders and partners in partnerships. In addition to avoiding the expense of complexity, computation of the deduction on the entity level also would avoid the prospect of a shareholder or partner receiving two K-1's from different entities and losing the deduction on one if the other has a loss.

Critics also argue that the limitations for income and for W-2 wages should be applied at the entity level. Passthrough owners also are at a disadvantage with respect to the 50% of W-2 wages limitation to the deduction. If QPAI as determined by taking into account only the items of the Sub S corporation allocated to the shareholder is barred from taking into account any W-2 wages of that Sub S corporation in computing their overall deduction.

Conclusions

Until final regulations are released and current issues settled, strategies should include re-evaluation of accounting methods to determine how easily they might be adapted to conform to existing regulations; maintaining present records of activities with as much detail as possible; keeping records for 2005 accessible in case amended returns should be filed as guidance develops and for those pass-through; owners with enough influence, timing entity-level disbursements and receipts based on the assumption that the IRS will continue not to allow computation of the deduction at the entity level. We are somewhat still at a wait and see attitude.