**Capturing Section 199 Tax Benefits – The Importance of Cost of Goods Sold Analysis**

Enacted as a replacement regime for the extraterritorial income exclusion, section 199 of the Internal Revenue Code allows “manufacturers” to reduce their federal income tax rate by up to 3.15%. The permanent tax benefit increases earnings per share and cash flow.

Most taxpayers that have “domestic production activities” are capturing the tax benefit by employing a process devised in 2005 either internally or with the assistance of an accounting firm. Depending on the sophistication of the taxpayer, and the resources it has committed to section 199 analysis, the process for capturing the benefit may have evolved considerably (or not) since its initial implementation.

One process improvement taxpayers may wish to consider is a more thorough analysis of how cost of goods sold (“CGS”) and CGS allocable to domestic production gross receipts (“DPGR”) are being determined for section 199 purposes. Most taxpayers, when reducing DPGR by CGS, start with CGS as determined for financial accounting purposes, and then make schedule M adjustments and certain other adjustments required under the uniform capitalization rules of section 263A. In order to avoid overstating CGS allocable to DPGR, it is important to carefully consider how costs are being allocated between qualifying and non-qualifying revenue. For example, an over-allocation of transportation, storage, or handling costs to qualifying activities may significantly diminish the section 199 benefit. It has been our experience that most taxpayers are performing very little analysis with respect to these costs.

A second, and potentially more significant, process improvement involves revisiting Treasury regulations §1.199-4(b) and considering how the text of the regulation aligns with the process actually employed. Our experience has been that most taxpayers have not carefully considered the text of §1.199-4(b). Instead, most taxpayers are relying on a general understanding of the requirement that DPGR must be reduced by allocable CGS.

For section 199 purposes, CGS for a given tax year generally is determined under the principles of section 263A. See Treas. Regs. §1.199-4(b)(1). CGS allocable to DPGR is determined in accordance with rules set forth in Treas. Regs. §1.199-4(b)(2). Thus, a proper application of section 199 requires a taxpayer to carefully consider §1.199-4(b)(2) when allocating its overall CGS for a particular tax year between “CGS allocable to DPGR” and “CGS allocable to non-DPGR.”

Rather than adopt an inflexible set of allocation rules, Treas. Regs. §1.199-4(b)(2) provides that CGS allocable to DPGR must be determined under a “reasonable method” that is “based on all of the facts and circumstances.” Thus, in order to properly compute qualified production activities income, a taxpayer must understand the array of inventoriable costs that are included in its CGS. Without that understanding, by default, taxpayers are forced to allocate CGS to DPGR without meaningful analysis.

An understanding of inventoriable costs, and how they relate to DPGR and non-DPGR, also is necessary in order to apply the more specific allocation rule set forth in Treas. Regs. §1.199-4(b)(2)(ii), which provides:

“If a taxpayer (other than a taxpayer that uses the small business simplified overall method of paragraph (f) of this section) recognizes and reports gross receipts on a Federal income tax return for a taxable year, and incurs CGS related to such gross receipts in a subsequent taxable year, then regardless of whether the gross receipts ultimately qualify as DPGR, the taxpayer must allocate the CGS to –

1. DPGR if the taxpayer identified the related gross receipts as DPGR in the prior taxable year; or
2. Non-DPGR if the taxpayer identified the related gross receipts as non-DPGR in the prior taxable year or if the taxpayer recognized under the taxpayer’s methods of accounting those gross receipts in a taxable year to which section 199 does not apply.”

Most taxpayers are allocating CGS for section 199 purposes without careful consideration of the scope of this specific allocation rule. For one not-particularly-convincing perspective on the scope of this rule, taxpayers should consider the IRS position set forth in CCA 200946037. Under the IRS position, the scope of the rule is limited to advance payments and revenue recognized by cash basis taxpayers. That interpretation finds very little support in the regulation.

An additional consideration in connection with CGS allocation is the extent to which a CGS ratio is being used to apportion “below-the-line” costs under the section 861 method. When such a ratio is employed, an overstatement of CGS allocable to DPGR further reduces the section 199 benefit by overstating the expenses properly allocable to DPGR.

PPTT has performed section 199 reviews for several of the largest taxpayers claiming section 199 benefits, as well as for a wide array of middle-market manufacturers. We would be delighted to discuss with you the likely benefit of a section 199 review.

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