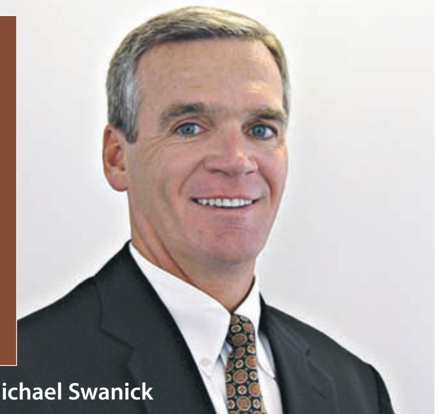
Section 199
Deduction for Qualified Production Activity Income

MICHAEL SWANICK, GLOBAL TAX LEADER FOR PHARMACEUTICAL INDUSTRY PRACTICE AT PRICEWATERHOUSECOOPERS, DISCUSSES THE MEANING OF "QUALIFIED PRODUCTION ACTIVITY INCOME" UNDER SECTION 199 OF THE AMERICAN JOBS CREATION ACT AND CONSIDERATIONS FOR PHARMACEUTICAL COMPANIES CLAIMING THE DEDUCTION.


Michael Swanick

In October of 2004, the U.S. Congress and President Bush signed into law the American Jobs Creation Act of 2004. The Act is the first major corporate tax act in over a decade. A key provision of the Act is a new domestic manufacturing deduction designed to improve the global competitiveness of U.S. multinationals, known as section 199.

Pharmaceutical companies, if they haven't already, should consider immediate phase-in planning to understand the impact that the section 199 deduction will have on their financial statements, including what disclosures should be made to address the impact of the deduction on their effective tax rate, cash flows, and estimated future tax benefits for accounting periods in 2005 and beyond, says Michael Swanick, global tax leader for the pharmaceutical industry practice at PricewaterhouseCoopers.

"In addition, they need to take into account the impact of the deduction as a special deduction under FASB Staff Position (FSP) FAS 109-1," he says. "Pharma companies should maintain substantial record keeping and/or documentation necessary to support their deduction. Finally, companies may be required to determine whether their existing reporting systems are capable of generating the information necessary to calculate the deduction."

According to Mr. Swanick, as a general matter, whether pharmaceutical companies are entitled to a deduction under section 199 will depend largely on the extent of their U.S. manufacturing operations. For example, a smaller company producing a single successful drug within the United States may be entitled to a significant benefit under section 199. On the other hand, he says, a larger, nondiversified pharmaceutical company may have difficulty qualifying unless it conducts a sufficient level of manufacturing activities in the United States.

"Further, as a practical matter, the benefit for such a company likely will be limited to a certain extent by its transfer pricing strategies," he says. "The opportunities for pharma companies will be shaped by how section 199 is interpreted by the IRS and applied in practice. For instance, large pharma companies with sophisticated transfer pricing strategies may not obtain a large benefit from section 199."

According to the PricewaterhouseCoopers' executive, there are several important open questions for pharmaceutical companies to consider. Accordingly, companies need to move promptly to analyze section 199 and the Notice in light of their business operations, identify the critical interpretive questions and take action where appropriate to seek a favorable outcome, either in the pending Technical Corrections bill or in the ongoing administrative guidance process under way by the IRS.

It should be noted, Mr. Swanick says, that the statutory language of section 199 and the Notice draw heavily on terminology that has appeared in other areas of the tax law. The IRS has said it will consider those precedents in preparing new guidance. In some cases, these precedents will not help pharma companies. Immediate awareness and, where appropriate, involvement by the pharmaceutical industry in the rule-making process is necessary.

KEY QUESTIONS FOR PHARMA COMPANIES UNDER SECTION 199.

ISSUE NO. 1: What activities of pharma companies will qualify as "manufactured, produced, grown, or extracted?"

Section 199 defines the term "domestic production gross receipts" to include gross receipts "derived from" any lease, rental, license, sale, exchange, or other disposition of qualifying production property that was "manufactured, produced, grown, or extracted" by the taxpayer in whole or "in significant part" within the United States.

The opportunities for pharma companies will be shaped by how section 199 is interpreted by the IRS and applied in practice.

"This has led many to question the extent to which pharma companies with substantial foreign operations would qualify for the deduction," Mr. Swanick says.

With respect to the phrase "manufactured, produced, grown, or extracted," the Notice states that the term includes activities relating to manufacturing, producing, growing, extracting, installing, developing, improving, and creating qualifying production property.

Mr. Swanick adds that the Notice also suggests, and the IRS has confirmed, that in determining whether a taxpayer's activities constitute "manufacturing," the "in significant part" requirement modifies both the "manufacturing" and the "within the U.S." requirements.

Because many companies conduct much of their manufacturing outside the United States, they may have difficulty satisfying some of the threshold requirements, in particular, the "in significant part" requirement. Mr.

Swanick says, however, a variety of activities of a pharmaceutical company (either directly or indirectly) may constitute qualified production activities.

"We'll discuss why primary and/or secondary manufacturing activities should not be disregarded for purposes of the 'substantial in nature' test and safe harbor rule, and what other requirements of the section must be satisfied, for example 'by the taxpayer,' and 'within the United States.'"

ISSUE NO. 2. **How should contract manufacturing arrangements be treated?**

Mr. Swanick says the Notice provides guidance on this issue that is contentious.

"According to the Notice, only one taxpayer — either the producer or the subcontractor — may claim the section 199 deduction with respect to a particular manufacturing activity," he says. "The Notice provides that only the taxpayer with the 'benefits and burdens' of ownership of the property at issue during the manufacturing process is considered the manufacturer. Factors to consider include the right to possession, title, and responsibility of loss, to name a few. Direct supervision and control is not determinative. If a subcontractor does not have the benefits and burdens of ownership during the manufacturing activity, the subcontractor is a mere service provider."

The contract manufacturing position may hurt certain industries, such as the pharmaceutical sector, where taxpayers often outsource segments of their manufacturing process to third parties. Unless the taxpayer maintains the benefits and burdens of ownership, the company will not be entitled to the deduction.

"The question of what constitutes the benefits and burdens of ownership is subject to dispute and may turn on one of many factors courts have used in making such determinations," he says. "Moreover, it may be difficult to apply in practice."

ISSUE NO. 3. **Will royalty income earned from third parties constitute eligible gross receipts?**

Pharma companies generally realize substantial revenue from royalties on the license of patents and know-how. Under section 199, Mr. Swanick explains that the definition of domestic production gross receipts includes "gross receipts of the taxpayer derived from any lease, rental, license, sale, exchange, or other disposition of 'qualifying production property' that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part with in the U.S."

Pharmaceutical companies need to understand the impact **that the section 199 deduction will have on their financial statements.**

He clarifies that royalty income from the licensing of qualifying production property to "related persons" is not qualifying gross receipts. Under section 199(a)(5), the term "qualifying production property" includes tangible personal property, computer software, and sound recordings.

Under well-established case law, patent rights are intangible property, not tangible property. Accordingly, a traditional royalty for the use of a patent, for example, for a drug compound, even if developed by the royalty recipient, would not be qualifying domestic production gross receipts because the patent is not qualifying production property, i.e., it is not tangible personal property.

ISSUE NO. 4. **How should Puerto Rican business operations be treated?**

To be eligible for a deduction under section 199, the qualifying production property must be manufactured in whole or in significant part within the "U.S." Section 199 does not define the term "U.S." Section 7701(a)(9), however, provides that the term "U.S." when used in a geographical sense includes only the states and the District of Columbia. Consistent with section 7701(a)(9), the Notice provides that the term "U.S." for purposes of section 199 includes only the 50 states and the District of Columbia along with the territorial waters of the United States and the continental shelf adjacent to those waters, but specifically does not include possessions and the territories of the United States or airspace over the United States.

Mr. Swanick says it is interesting to note that the production activities of a possessions corporation — section 936 — that is a member of a pharma company's expanded affiliated group (EAG) may be attributed to the pharma company for determining whether the company is engaged in a qualified production activity (under the EAG rules), but not for determining whether the manufacturing activities are considered to be within the United States. However, given the section 936 and section 30A phase out, pharmas that have not done so already should examine their section 199 strategies in light of the phase out.

ISSUE NO. 5. **Will some pharma companies have difficulty meeting the "actual conduct of a trade or business" requirement?**

Section 199 applies by only taking into account items that are attributable to the "actual conduct of a trade or business."

"Neither section 199 nor its legislative history defines the phrase 'actual conduct of a trade or business,'" Mr. Swanick says. "Further, no other section of the Code defines the phrase."

Given the lack of statutory definition regarding the phrase "actual conduct of a trade or business" for purposes of section 199, the scope of this limitation is unclear. The term "actual" as used in section 199 is not the same as the term "active" used elsewhere. Thus, it cannot be determined with any degree of certainty whether the two terms will be interpreted similarly by the IRS, he says.

ISSUE NO. 6. **To what extent will a nondiversified large pharmaceutical company benefit from section 199?**

Under section 199, a taxpayer's qualified production activity income cannot exceed its taxable income.

"Taxable income for this purpose is defined by section 63, i.e., after a net operating loss carryovers and carrybacks," Mr. Swanick explains. "Accordingly, taxable income effectively limits the extent to which a taxpayer may benefit from a deduction under section 199."

Transfer pricing strategies may limit the extent to which a company may benefit from a deduction under section 199 because of the taxable income limitation.✦

PricewaterhouseCoopers, New York, has extensive experience working with industry organizations, including multinational pharmaceutical corporations, proprietary and generic drug manufacturers, specialty drug makers, medical-device and diagnostics suppliers, biotechnology companies, wholesalers, pharmacy benefit managers, CROs, and industry associations. For more information, visit pwc.com/pharma.

PharmaVOICE welcomes comments about this article. E-mail us at feedback@pharmavoice.com.