Domestic Production Activities Deduction (Section 199): Ineffective Tax Policy

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The domestic production activities deduction provided under Section 199[1] of the Internal Revenue Code (IRC) is a poorly-targeted policy that creates inefficiency in the tax code while draining resources from other job-creating investments or broader tax reductions.

The Joint Committee on Taxation estimates that the production activity deduction will result in $78.2 billion of forgone tax revenue for the years 2013 through 2017.[2]

Origin

The U.S. previously provided incentives for the export of U.S. manufactured goods through exclusion for extraterritorial income (ETI).[3] This subsidy was found to be illegal under World Trade Organization (WTO) rules and was repealed in 2004. Section 199 was included in the American Jobs Creation Act of 2004 (PL 108-357) an effort to replace the benefit that U.S. exporters were losing in a manner that was permissible under WTO rules. The Section 199 domestic production deduction differs from the ETI in that it significantly broadened the range of activities that could qualify for the benefit and no longer required that qualifying activities result in products for export.

What It Does

The net income from business activities is generally taxed at the rates specified in the IRC, which are as high as 39.6 percent for individuals and 35 percent for corporations. For income from qualified domestic production activities, the code allows an additional deduction equal to 9 percent of income derived from the activity. The deduction is designed to be approximately a 3-percentage-point reduction in the tax on eligible activities. Thus, it effectively reduces the top rates from 35 percent to 31.85 for corporations and from 39.6 percent to 36.04 for individuals for qualifying activities.

In the case of oil and gas production activities, Congress limited the special deduction to 6 percent in 2008. For these producers, the special deduction reduces the top corporate rate on eligible income from 35 percent to 32.9 percent and the top individual rate from 39.6 percent to 37.22 percent.

[1] 26 U.S.C sec. 199
[2] Congress, Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017" (Feb. 1, 2013)
[3] Former 26 U.S.C. secs. 144 and 941 – 943.

Why It Doesn't Work

Although the stated concern of Congress was retention of U.S. manufacturing jobs and investment, the special deduction applies to activities that could not realistically be sent abroad. Qualifying activities are loosely defined and complicated. Sec 199 identifies qualifying income as receipts derived from disposition of property "which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States." However, it does not define the words "manufactured," "produced," "grown," etc. Courts are often left to decide what qualifies as "production."[4]

Roughly one-third of all U.S. corporate activity now qualifies for this deduction, including mining, oil extraction, farming, construction, architecture, engineering and the production of software, recordings and films. Construction of real property in the U.S. that is eligible for the deduction includes the construction of residential or commercial buildings, swimming pools, parking lots, roads, and sidewalks[5]. Electrical, plumbing, heating and air-conditioning contractors qualify. Like other qualifying activities, the jobs associated with the production of oil and gas from *domestic* wells cannot be moved abroad. Qualifying production activity does not need to result from or in exports.

The cost to taxpayers in terms of foregone revenue of the deduction is hard to justify. From the beginning of 2005 when the deduction became available to the beginning of 2013, the wellhead price of domestic oil rose nearly 130 percent. In contrast, the producer price index for all manufacturing rose only 32 percent and consumer prices rose 21 percent.[6] The dramatic increase in the value of oil and gas production has had a far greater impact on the oil industry's decision to invest in new domestic wells than the tax benefit of this special deduction.

Section 199 doesn't require a producer to demonstrate that any new jobs were created by the qualifying activity. Indeed, if a producer is able to increase net income by cutting wages and benefits or replacing workers with machines, the result would be an increased production activity deduction. The jobs associated with qualifying income do not need to be skilled or high-wage jobs. Non-production activities that create substantial economic benefit and high-skilled jobs, such as medical research, do not qualify for the subsidy.

Not surprisingly, the level of domestic manufacturing appears unaffected by the introduction of the production activity deduction. Almost a decade after enactment, the level of domestic manufacturing has continued its steady decline from the 1950s. The Bureau of Labor Statistics reports the manufacturing sector accounted for only 8.1 percent of domestic jobs in 2010, and will further decline to 7 percent by 2020.[7]

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[4] A federal district court ruled that the act of putting wrapped candy bars and wine bottles into gift baskets qualifies for the deduction.4 If a company produces a product and sells it in its own retail outlets, the retail sale can qualify for the deduction, unless the product is further prepared immediately prior to sale, such as food or beverage for consumption (the so-called "Starbucks Footnote"). Thus, roasted and packaged coffee is eligible, but a cup of coffee is not.

[5] Daniel Karnis, "Maximizing the Section 199 Deduction," Journal of Accountancy (September 2010): http://www.journalofaccountancy.com/Issues/2010/Sep/20102727.htm

[6] Calculated from U.S. Bureau of Labor Statistics data

[7] Bureau of Labor Statistics , Employment Projections, 2.1 Employment by major industry sector at: http://www.bls.gov/emp/#tables

Conclusion

No reasonable case can be made that other qualifying activities would not have taken place in the absence of the deduction, especially when the opportunity cost of the foregone revenue as a consequence of the deduction. At a cost of $100 billion over the next ten years, the domestic production activities deduction is not worth the money.