SECTION 199

Overview

- Section 199 of the Internal Revenue Code was enacted as part of the American Jobs Creation Act of 2004 to maintain and create U.S. employment by promoting manufacturing and production activities (e.g. construction, software development) taking place in the United States by providing an additional tax deduction to taxpayers that carry on these activities.

- The tax rules allow a special incremental deduction under Section 199 generally equal to 9% of income from qualifying production activities. Thus, for a corporate taxpayer generally subject to a 35% U.S. corporate income tax rate, the deduction is equivalent to a tax rate reduction of approximately 3 percentage points on qualified manufacturing earnings, resulting in an effective tax rate of approximately 32% on qualifying income.

- The rules do provide certain limitations. For example, the Section 199 deduction cannot exceed 50% of the wages related to manufacturing or production activities paid by the taxpayer in a particular year. In addition, the income that the 9% deduction is based on is limited to taxable income if that amount is less than income from qualifying production activities.

Example of §199 – Tax Return

- Taxpayer manufactures products in the U.S. and sells them around the world, earning $10,000,000 of net income from qualifying production activities. Taxpayer will be entitled to a $900,000 deduction under Section 199. At the U.S. corporate tax rate of 35%, Taxpayer will owe approximately $3,185,000 of tax, rather than the $3,500,000 of tax that would result in the absence of Section 199.

	Without Manufacturing Deduction	With Manufacturing Deduction
Taxable Income before the Manufacturing Deduction	$10,000,000	$10,000,000
Sec. 199 – Manufacturing Deduction @ 9%		<900,000>
Taxable Income after the Manufacturing Deduction	$10,000,000	$9,100,000
Federal Tax @ 35% (rounded)	$3,500,000	$3,185,000

The benefit derived from the deduction for qualified manufacturing income under Section 199 is an example of a "permanent" difference between book income and taxable (cash) income

- In the example below, it is assumed that the company, Taxpayer, qualifies for the manufacturing deduction under Section 199. This benefit results in a permanent difference as the manufacturing deduction reduces taxable income on the tax return but does not reduce Taxpayer's income on the financial statements *and this difference does not reverse over time*. In this example, the manufacturing tax benefit has permanently increased the company's income by $315,000, which results in an effective tax rate of approximately 32% ($3,185,000 divided by $10,000,000).

	Financial Statement		**Tax Return**
Sales	$30,000,000	Sales	$30,000,000
Cost of Goods	<15,000,000>	Cost of Goods	<15,000,000>
Other Expenses	<5,000,000>	Other Expenses	<5,000,000>
		Taxable (Cash) Income before Section 199 Manufacturing Deduction	10,000,000
		Sec. 199 Manufacturing Deduction @ 9%	<900,000>
Book Income Subject to Tax	10,000,000	Taxable (Cash) Income	9,100,000
Federal Taxes @ 35% Statutory Rate	<3,500,000>	Federal Taxes @ 35% Statutory Rate	<3,185,000>
Tax Benefit of Sec. 199	315,000		
Total Federal Tax Expense	<3,185,000>		
Net Book Income	$6,815,000		
Tax Rate	32%		35%

(rounding)