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Jasmine Wu Ting

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Repeal of the IRC §199 Domestic Production Deduction

By Jasmine Wu Ting, MST Student

Introduction

While the United States is slowly recovering from a prolonged recession, tax reform has been one of the most debated topics among lawmakers in Washington, D.C., particularly in 2011. In his State of the Union speech, President Obama called for reform of the corporate income tax system. He suggested the need to “get rid of the loopholes… to lower the corporate tax rate without adding to our deficit.”

A number of provisions in the tax system narrow the tax base, distort the economic activity and increase the complexity of the tax code. President Obama's National Commission on Fiscal Responsibility and Reform, estimated that tax expenditure total about $1.1 trillion. Eliminating these provisions could increase tax revenues significantly and improve efficiency of the system.

One of the above mentioned expenditures is the Domestic Production Deduction (IRC §199) which results in an estimated revenue loss of $210 billion over 10 years. The domestic production deduction was first introduced to the tax system in 2004 allowing businesses to deduct part of their earnings from certain kinds of domestic production from their taxable income. The purpose of this provision is to encourage manufacturing production in the U.S. The scope of the definition of “production” is quite broad. Many business sectors, from software development to food processing and filmmaking, benefit from the deduction.

Eliminating this provision would raise enough revenue to allow a 1.1% reduction in the corporate tax rate. Moreover, it would simplify the tax code because the definition of...

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qualifying production and other elements of the deduction are complex which increases compliance and administrative costs.

Understandably, organizations that benefit from this provision may fight to keep it in the Code. In early 2011, President Obama unveiled his fiscal year 2012 federal budget proposal which included repeal of the Section 199 deduction for oil and natural gas companies. The National Association of Manufacturers (NAM) responded by stating that such repeal would increase energy costs and hurt job creation.

On the other hand, full repeal of Section 199 has received support from some corporations. Some corporate executives testifying before lawmakers endorsed the concept of eliminating the domestic manufacturing deduction in exchange for simplifying the tax law and lowering the corporate tax rate. They stated that management could be more productive and increase hiring if it could spend less time and money on tax compliance. Walter Galvin, vice chairman of Emerson Electric, told lawmakers, “We as a country have been tinkering with credits and deductions that, while well-intentioned, have done little more than encourage complex tax planning.”

Principles of Good Tax Policy Evaluation

The following chart explains how the principles of good tax policy apply to the proposal to eliminate the Domestic Manufacture Deduction (Section 199). The analysis uses the ten principles of good tax policy outlined in the AICPA Statement #1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposal.

<table>
<thead>
<tr>
<th>Principle</th>
<th>Application</th>
<th>Rating</th>
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<tr>
<td>Equity and Fairness</td>
<td>The manufacturing industry has benefited from the domestic production deduction. This deduction though discriminates against other business sectors and distorts economic decisions as it does not apply to all domestic production. Eliminating this provision will increase equity and fairness as business with similar characteristics will be treated similarly regardless of their industry sector.</td>
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| **Certainty** | Eliminating the domestic production deduction will increase certainty because the definition of qualifying production and other elements of calculating the deduction are complex. Taxpayers take great efforts to figure out what receipts and production can be considered in calculating the deduction. Eliminating this deduction would result in considerable tax simplification. | + |
| **Convenience of Payment** | Eliminating the domestic production deduction will have no affect on the timing of payment by corporate taxpayers. Corporations will pay their taxes at the same manner whether the deduction exists or not. | n/a |
| **Economy in Collection** | Eliminating the Section 199 provision will improve economy in collection. The IRS will collect fewer forms and need less audit time to ensure that taxpayers who claim this deduction are in full compliance with the law. Elimination will also reduce the time taxpayers spend in producing and maintaining records needed to determine the deduction. | + |
| **Simplicity** | Eliminating the domestic production deduction will significantly simplify the tax code. Because the scope of the definition of “production” is broad, many business taxpayers spend considerable time and money on compliance and administration each year. Eliminating this provision will be cost-efficient for taxpayers. | + |
| **Neutrality** | The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum. Currently the domestic production deduction applies to both corporate and non-corporate business. If the deduction is repealed for corporate taxpayers only, businesses may be motivated to choose a non-corporate organizational form. However, if the deduction is repealed for all business taxpayers, there will be no effect on decisions of entity form. Repeal will also reduce any effect the deduction may have on businesses practices to engage in the types of activities and distribution practices that generate a deduction. If the deduction is eliminated and the corporate tax rate reduced below 35%, some businesses may be motivated to become corporations to benefit from the lower corporate rate (if double taxation is not a concern for them). |
| **Economic Growth and Efficiency** | Eliminating the domestic production deduction would broaden the tax base and therefore raise tax revenues. Increased revenue could allow a reduction in the corporate tax rate which, in return, may improve the competitiveness for US businesses. Removal will also reduce the incentive to invest in companies that generate this deduction. |
| **Transparency and Visibility** | Eliminating the Section 199 deduction should improve transparency and visibility. Taxpayers in all businesses would then know that no such deduction exists for a business in manufacturing. Tax reporting and calculations would be more transparent and visible for taxpayers in all business sectors. The Section 199 deduction could instead have been implemented as a tax rate reduction. Elimination with a rate reduction will be more transparent in knowing the effective tax rate of a business. |
| **Minimum Tax Gap** | Eliminating the domestic production deduction will reduce the tax gap because the complexity of the provision may lead to inadvertent errors. |

- If repealed for corporations only or only for specified industries.

+ If repealed for all taxpayers.
Appropriate Government Revenues
The tax system should enable the government to determine how much tax revenue will likely be collected and when.

The Treasury Department has data from past tax returns demonstrating the lost revenue due to the provision. Thus, the government can easily determine how much tax revenue would be collected if this provision is no longer in existence.

Conclusion
Repeal of the Section 199 domestic production deduction for all taxpayers meets all the principles of good tax policy. If the deduction is only repealed for corporations or certain industries (such as oil and gas), the neutrality principle is not met. Repeal has no effect on the convenience of payment principle.

To address the neutrality issue, Congress could apply the proposed elimination to all business/taxpayers, instead of only for corporate taxpayers or particular industries.