Silicon Valley
TAX DIRECTORS GROUP

2121 41st Avenue
Suite 301
Capitola, CA 95010
PHONE 831.465.8204
FACIMILE 831.465.9384

www.svtdg.org
info@svtdg.org

November 24, 2015

<u>VIA ELECTRONIC TRANSMISSION AND HAND-DELIVERY</u>

CC:PA:LPD:PR (REG–136459–09)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on proposed § 199 regulations in REG–136459–09

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group ("***SVTDG***") hereby submits these comments on the above-referenced proposed regulations issued under § 199 of the Internal Revenue Code of 1986, as amended, in REG–136459–09, 80 Fed. Reg. 51978 (August 27, 2015). SVTDG members are listed in the Appendix of this letter.

I respectfully request an opportunity to present oral comments, on behalf of the SVTDG, at the public hearing on December 16, 2015. An outline of the topics I propose to discuss, and the approximate time devoted to each topic, is given on the next page.

Sincerely,

Robert F. Johnson

Robert F. Johnson
Co-Chair, Silicon Valley Tax Directors Group

Topics to be discussed at December 16, 2015 Public Hearing

1. Recommendation that the current BBO rule not be replaced [≈ 8 minutes, total]

   a. § 199, its purposes, and the current BBO rule [≈ 2 minutes]

   b. The rule proposed to replace the current BBO rule, and its effect [≈ 1 minute]

   c. The proposed rule isn't supported by its stated justifications [≈ 2 minutes]

   d. The proposed rule is inconsistent with the purposes of § 199 [≈ 2 minutes]

   e. If the proposed rule is finalized, the suggested limited exception for cost-plus arrangements should be included [≈ 1 minute]

2. Recommendation that testing, per se, shouldn't be excluded as an MPGE activity [≈ 2 minutes]

I. INTRODUCTION AND SUMMARY

A. Background on the Silicon Valley Tax Directors Group

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley, that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace.

B. Recommendation that the current BBO rule not be replaced

A taxpayer's deduction under § 199 depends on a taxpayer's domestic production gross receipts ("***DPGR***"), defined to include the taxpayer's gross receipts derived from the sale or disposition of qualifying production property ("***QPP***") that was manufactured, produced, grown, or extracted ("***MPGE***") by the taxpayer in whole or in significant part within the U.S.

In a situation involving a U.S. contract manufacturer ("***CM***") manufacturing products for a taxpayer principal, the current BBO rule in § 1.199-3(f)(1) provides that the party with the benefits and burdens of ownership of QPP under Federal income tax principles (the "***BBO***") during the period of manufacturing is treated as engaging in the manufacturing. The current BBO rule attributes to the taxpayer principal the CM's manufacturing activities if, as is common, the taxpayer principal has the BBO. The taxpayer principal's gross receipts from the sale of the QPP can thus constitute DPGR if the attributed manufacturing activities are substantial in nature. By contrast, if in this situation the CM has the BBO, the current BBO rule attributes to the CM the manufacturing activities it actually performs, and the CM's gross receipts from disposing of the QPP can constitute DPGR if the activities are substantial in nature. The current BBO rule ensures only one party gets a manufacturing deduction with respect to the sale of the QPP, because only one party can have the BBO during manufacture.

The proposed regulations[1] remove the current BBO rule and impose a new rule whereby the party actually performing an MPGE activity is always treated as performing the activity. In a contract manufacturing situation, consequentially, a taxpayer principal <u>would never</u> be attributed MPGE activities. The taxpayer principal's gross receipts from disposing of QPP manufacture by a CM <u>would never</u> constitute DPGR. The taxpayer principal <u>would never</u> get a § 199 deduction. We recommend the proposed rule be withdrawn and the current BBO rule be allowed to stand.

The Treasury Department and the IRS have failed to consider an important aspect of this issue. The determination of DPGR (in all cases in which there's a sale of QPP) turns on <u>which</u> taxpayer has BBO of the QPP. A sale of property for tax purposes rests on the legal conclusion that the BBO of that property have been transferred. If a CM doesn't have the BBO of the QPP

[1] REG–136459–09, 80 Fed. Reg. 51978 (August 27, 2015).

during the time of manufacture, the CM can't sell the QPP and its gross receipts can't constitute DPGR. In this extremely common case neither the CM nor the principal would derive DPGR from the sale of the QPP—no § 199 deduction could be claimed by either party. Determination of BBO is an essential process.

The proposed regulations give three alleged justifications for replacing the current BBO rule with the proposed rule, but two are false and the third certainly doesn't justify replacing the current BBO rule. First, the proposed rule is no more administrable than the current BBO rule because—as just explained—a BBO determination must <u>still be made</u> to determine if a CM's gross receipts constitute DPGR. Second, and for the same reason, the proposed rule won't reduce the burden on taxpayers and the IRS in evaluating BBO factors. In any event this burden, under an LB&I Industry Director Directive, falls initially and primarily on taxpayers. Third, admittedly the proposed rule prevents more than one taxpayer from being allowed a § 199 deduction with respect to any MPGE activity, but so does the current BBO rule, so why not keep the current BBO rule?

Importantly, the proposed rule is contrary to the purposes of § 199. First, in a U.S. contract manufacturing situation, the effect of the proposed rule—denying the taxpayer principal a deduction—will likely drive such taxpayers to use lower cost foreign CMs. The proposed rule is thus almost certain to <u>reduce</u> U.S. manufacturing jobs and capabilities. The Treasury Department and the IRS have pointed to no evidence suggesting the proposed rule is likely to preserve, or not materially lower, the amount of U.S. manufacturing jobs. Second, again in a contract manufacturing situation, the proposed rule will result in <u>no</u> § 199 deduction being available to the CM if the principal has BBO of the QPP during the manufacturing period. This follows because the CM needs BBO of the QPP before it can sell or dispose of the QPP and derive DPGR. We believe this will occur in <u>many</u> cases. The resulting evaporation of § 199 deductions in U.S. contract manufacturing situations is contrary to the Congressional intention that money from the repeal of FSC/ETI regimes be used to support U.S. manufacturing.

Although the SVTDG strongly believes the proposed rule denying attribution of MPGE activities to the party having the BBO should <u>not</u> be finalized, if the Treasury Department and the IRS insist on finalizing the proposed rule, the cost-plus exception described in the proposed regulations should be included. The proposed exception would, in some situations, prevent some of the problems described above. The SVTDG recommends a "materiality" threshold should be added to the cost-plus exception to prevent contractual arrangements from being disqualified from the exception by failures to reimburse de minimis costs.

C. Support for proposed and temporary regulations dealing with W-2 wages in the cases of an acquisition

Proposed rules (and their temporary equivalents) modify the § 199(b) W-2 wage limitation for acquisitions and dispositions. W-2 wages are proposed to be allocated between multiple taxpayers based on the period during which employees of the acquired or disposed of trade or business were employed by each taxpayer. In the case of a short taxable year not including a calendar year end, W-2 wages are proposed to be those wages paid to employees in the short taxable year. The SVTDG believes these proposed and temporary rules are sensible and practical applications of the W-2 wage limitation in the context of acquisitions and dispositions.

D. Recommendation that testing per se shouldn't be excluded as an MPGE activity, and that *Example 5* of § 1.199-3(e)(5) should be removed

Treasury and the IRS signaled in the preamble to the proposed regulations their belief that testing activities, alone, can't qualify as an MPGE activity. We disagree with this, and recommend testing be taken into consideration in determining a taxpayers MPGE activities. Testing of components and products can be of a fundamentally different character and importance than other activities carved out from MPGE (i.e., packaging, repackaging, labeling, minor assembly, and installation). In the high tech industry, for example, component and product testing can cost as much, take as much time, and add as much or more value, as assembling the product; can involve considerable efforts of many engineers and manufacturing specialists; and can involve development and use of sophisticated, extensive software. The blanket exclusion of testing as an MPGE activity in all cases ignores the role of product testing in the manufacturing process, which is wrong. The facts-and-circumstances "substantial-in-nature" test under § 1.199-3(g)(2) allows the IRS to assess the contribution of testing to the overall manufacturing process on a case-by-case basis.

We also recommend *Example 5* of § 1.199-3(e)(5) be removed. It gives no guidance on how to determine if activities performed by a taxpayer are MPGE, instead beginning with the conclusory statement that a party "MPGE QPP within the United States." As described more fully below, *Example 5* is confusing, and will undoubtedly lead to disputes and wasted IRS and taxpayer resources.

II. SPECIFIC CONCERNS WITH PROPOSED § 199 REGS IN REG–136459–09

A. Background on § 199 and the current BBO rule

A taxpayer's deduction under § 199 depends on the taxpayer's DPGR, defined to include the taxpayer's gross receipts derived from "any lease, rental, license, sale, exchange, or other disposition" of "[QPP] which was [MPGE] by the taxpayer in whole or in significant part within the United States."[2] In a situation in which a taxpayer sells to customers QPP made by a U.S. CM hired by the taxpayer (principal), the taxpayer can't—absent some mechanism—get a § 199 deduction because the taxpayer didn't perform the MPGE activities. Without the § 199

[2] § 199(c)(4)(A)(i)(I).

deduction, the U.S. taxpayer principal has much less incentive to hire U.S. CMs, and would likely hire a foreign CM (likely at a lower cost to the principal). U.S. CMs don't manufacture of their own accord—they depend on principals hiring them. The flight of manufacturing from the U.S. is in large part because it's cheaper to make QPP abroad, so giving principals an incentive to hire U.S. CMs helps counter this flight and promotes U.S. manufacturing capabilities.

Paragraph 1.199-3(f)(1) of the current regulations alleviates this harsh outcome. It provides that—in a U.S. contract manufacturing situation—the party that has the BBO during the period of manufacture is treated as engaging in the manufacturing (the "***current BBO rule***"). A taxpayer principal that has the BBO of the QPP during the period of manufacture is thereby attributed the manufacturing activities. The taxpayer's gross receipts from selling the QPP to customers can thus qualify as DPGR because the taxpayer is deemed to have made the QPP it sold to customers. The taxpayer can, if the U.S. manufacturing activities are sufficiently substantial, get a § 199 deduction, so it's incentivized to hire U.S. CMs.

Alternatively if, in a U.S. contract manufacturing situation, the CM has the BBO of QPP during the period of manufacture, the CM is deemed under the current BBO rule to have made the QPP it in fact made. The CM's gross receipts from disposing of the QPP can qualify as DPGR. The BBO of QPP lies only with the principal or the CM (not both), so the current BBO rule ensures only one party gets a § 199 deduction with respect to the QPP.

Significantly, the economics of such contract manufacturing situations are such that the § 199 deduction a principal can get is in many cases much greater than any deduction the CM could get. This follows because operating margins CMs make are typically quite small—they typically provide industry standard manufacturing services and make more profit by making more products.

B. The proposed rule relating to contract manufacturing arrangements

1. The proposed rule and its effect

The proposed regulations remove the current BBO rule and impose a new rule whereby only the party actually performing a MPGE activity is the taxpayer treated as engaged in the qualified activity.[3] In a contract manufacturing situation the principal would never be attributed manufacturing activities carried out by the CM. The proposed rule therefore has the effect of denying a § 199 deduction to the principal in contract manufacturing situations.

---

3 Prop. § 1.199-3(f)(1).

2. The proposed rule isn't supported by the stated justifications

The preamble states three justifications for the proposed rule: (i) "provide administrable rules that are consistent with section 199," (ii) "reduce the burden on taxpayers and the IRS in evaluating factors related to the benefits and burdens of ownership," and (iii) "prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any qualifying activity."[4] These alleged justifications don't actually support the proposed rule.

a. The proposed rule won't be any easier to administer

The first ("provide administrable rules") and second ("reduce the burden on taxpayers and the IRS") justifications both relate to the perceived difficulty and expense in evaluating BBO factors. These justifications fail to support the proposed rule because the Treasury Department and IRS have failed to consider an important aspect of § 199: a taxpayer can only claim a deduction under § 199 if it has DPGR, and DPGR in all cases where there's a sale of QPP turns on the determination of BBO. Under § 199(c)(4)(A)(i), DPGR are gross receipts from "any lease, rental, license, sale, exchange, or other disposition" of QPP. A taxpayer that doesn't lease, rent, license, sell, exchange, or otherwise dispose of QPP won't have DPGR and won't be able to claim a § 199 deduction.

BBO determination is fundamental for tax purposes. Whether a taxpayer sells property depends on whether the BBO of that property have transferred.[5] If a CM doesn't have the BBO of the QPP during the time it performs MPGE activity, it's not possible for the CM to sell or dispose of the QPP. Determining whether a CM has DPGR in a contract manufacturing situation therefore still requires a determination of whether a CM has BBO, thus an examination of the BBO factors. The proposed rule therefore won't result in a reduction in the burden of evaluating the BBO factors.

b. The initial burden for evaluating BBO currently falls primarily on taxpayers

It's unclear why the Treasury Department and IRS describe the current rules as so burdensome as to warrant such a significant change. The preamble to the proposed regulations mentions *ADVO, Inc. & Subsidiaries v. Commissioner*,[6] in which the Tax Court analyzed BBO

---

[4] 80 Fed. Reg. at 51982.

[5] *See, e.g.*, *Sollberger v. Commissioner*, 691 F.3d 1119, 1124 (9th Cir. 2012) ("To determine whether a sale occurs for tax purposes, we continue to apply a flexible, case-by-case analysis of whether the burdens and benefits of ownership have been transferred."); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981) ("The key to deciding whether petitioners' transactions with [purported sellers] are sales is to determine whether the benefits and burdens of ownership have passed from [purported sellers] to petitioners.")

[6] 141 T.C. 298 (2013).

factors to determine whether a direct mailing company was entitled to a § 199 deduction for qualifying activity performed by a contract printer. The preamble doesn't state, however, why such an analysis is overly burdensome. Many tax law outcomes turn on facts-and-circumstances tests (e.g., determining whether an instrument constitutes debt or equity). Industry Director Directive, LB&I Control No. LB&I-04-1013-008 (Oct. 29, 2013), under the current regulations, lets taxpayers make a determination as to which party in a contract manufacturing arrangement had the BBO, and prepare a statement to be provided to an IRS examiner upon request explaining the taxpayer's determination. The taxpayer also provides the IRS examiner with statements from the taxpayer and the counterparty certifying that only the taxpayer is entitled to the § 199 deduction and the counterparty won't claim a § 199 deduction with respect to the qualifying activity. The initial, primary burden in determining BBO now falls on taxpayers, with the IRS able to review taxpayers' determinations. While these rules undoubtedly require some effort, the SVTDG—whose members include both principals and CMs—doesn't find the current rules unduly burdensome. Characterization of a transaction is a critical part of U.S. tax law, and a multi-factor determination is often required. Avoiding such a determination isn't a good reason to sharply limit the availability of a Congressionally-intended deduction.

c. The current rule adequately prevents more than one taxpayer from claiming the deduction

The third justification—preventing more than one taxpayer from claiming a deduction for the qualifying activity—alone doesn't justify the proposed rule. The current BBO rule adequately prevents more than one taxpayer from claiming a § 199 deduction for the qualifying activity. Given that under the Industry Director Directive the counterparty in a contract manufacturing arrangement must agree not to claim a § 199 deduction for the qualifying activity, it's difficult to imagine how two taxpayers could claim a deduction for the qualifying activity. Unsurprisingly, the preamble to the proposed regulations doesn't mention any examples in which the current rules fail to prevent two taxpayers from claiming a deduction for the qualifying activity.

3. The proposed rule is inconsistent with the purposes of § 199

a. Congress enacted § 199 to support U.S. manufacturing

The proposed rule is inconsistent with the purposes of § 199. The legislative history of § 199 is clear that Congress enacted the deduction to create and retain U.S. manufacturing jobs. Section 199 was enacted to "make investments in domestic manufacturing facilities more attractive," which will "create and preserve U.S. manufacturing jobs."[7] Section 199 was precipitated by the repeal of the Extra-Territorial Income ("***ETI***") and Foreign Sales Corporation ("***FSC***") regimes and was intended to use "every penny from the FSC/ETI bill repeal" on a

[7] H.R. REP. NO. 108-548, at 115 (2004).

deduction for "all income derived from manufacturing . . . done in the United States . . . ."[8] Section 199 was therefore intended to prevent a "$50 billion tax increase on manufacturing" that would have otherwise resulted from FSC/ETI repeal.[9]

The proposed rule would undercut these purposes at least two ways. First, in contract manufacturing situations in which a § 199 deduction is still available (i.e., in which the CM has the BBO of QPP during the manufacture), the magnitude of the deduction—and the corresponding incentive for companies to hire U.S. CMs to manufacture in the U.S.—is likely to be substantially reduced. As noted above, the § 199 deduction for CMs is typically much smaller than the § 199 deduction for principals because CMs typically have lower operating margins. The SVTDG expects many principals would hire foreign CMs, which are generally cheaper than U.S. CMs, even taking into account a deduction allowed to the CM. The proposed rule is therefore contrary to the purpose of investing in U.S. manufacturing facilities and retaining U.S. manufacturing jobs. U.S. CMs will suffer as the companies that hire them lose their § 199 deduction. The Treasury Department and IRS have pointed to no evidence demonstrating the proposed rule is likely to preserve, or at least not materially lower, the amount of U.S. manufacturing jobs.

Second, there'll be significantly fewer situations in the contract manufacturing context in which a § 199 deduction is available at all. In the experience of members of SVDTG, it's common for a <u>principal</u> to have the BBO in contract manufacturing arrangements. In this common situation the principal would be denied a deduction under the proposed rule, and the CM won't have sold or disposed of the property (because it can't transfer BBO it doesn't have), so <u>no party</u> would get a § 199 deduction. The amounts Congress intended to be returned to the manufacturing sector via a § 199 deduction would be blocked by the proposed rule. The SVTDG believes these situations would be fairly common. The IRS has seen a large sample size of contract manufacturing arrangements. The IRS, however, has produced no study or other evidence showing the effect of the proposed rule on aggregate § 199 deductions.

The combined effects of the proposed rule—severely curtailed availability of any § 199 deduction in contract manufacturing situations, and significantly smaller deductions when available—is in effect a significant tax increase on the U.S. manufacturing sector and is likely to cost a significant number of U.S. manufacturing jobs. The second, related purpose of § 199—to return the projected proceeds from FSC/ETI repeal to the manufacturing sector via a deduction—will also be thwarted.

---

[8] 150 CONG. REC. 3,120 (2004) (statement of Sen. Chuck Grassley, sponsor of bill S. 1637).

[9] 150 CONG. REC. 22,972 (2004) (statement of Sen. Chuck Grassley).

b. Congress implicitly approved of principals being allowed § 199 deductions in some circumstances

While the language of § 199 doesn't explicitly address contract manufacturing, § 199(d)(10) instructs the Treasury Department to prescribe regulations that prevent more than one taxpayer from being allowed a § 199 deduction with respect to any qualifying activity. Contract manufacturing appears to be the primary situation in which two taxpayers might claim a § 199 deduction with respect to a qualifying activity. Had Congress wanted to deny a deduction to principals in contract manufacturing arrangement, it could have readily done so. It chose not to. Congress instead directed the Treasury Department to prescribe regulations, necessary to carry out the purposes of § 199, including preventing more than one taxpayer from claiming a deduction with respect to a qualifying activity. The common sense inference is that Congress intended either a principal or a CM—but not both—to be able to claim a § 199 deduction with respect to a qualifying activity. A blanket prohibition on § 199 deductions for principals is therefore contrary to Congress's intent implied by § 199(d)(10).

The proposed rule undercuts the purposes of § 199 without increasing administrability. The proposed rule with respect to contract manufacturing arrangements therefore should not be finalized and the current BBO rule should be maintained.

4. If the proposed rule is retained, the suggested limited exception for cost-plus arrangements should be included

The Treasury Department and IRS requested comments on "whether there should be a limited exception to the proposed rule for certain fully cost-plus or cost-reimbursable contracts." Under this exception, the principal would be treated as the taxpayer engaged in the qualifying activity if the CM is "(i) reimbursed for, or provided with, all materials, labor, and overhead costs related to fulfilling the contract, and (ii) provided with an additional payment to allow for a profit" (the "***cost-plus exception***"). The Treasury Department and the IRS specifically requested comments on (1) the rationale for the proposed exception, (2) the ability of the IRS to administer the exception, and (3) how the suggested exception will prevent two taxpayers from claiming the deduction for the qualifying activity.

Although the SVTDG strongly believes the proposed rule denying attribution of MPGE activities to the party having the BBO should <u>not</u> be finalized, if the Treasury Department and the IRS insist on finalizing the proposed rule, the cost-plus exception should be included. As described below, the proposed exception would, in some situations, prevent some of the problems described above. The SVTDG also believes a "materiality" threshold should be added to the cost-plus exception to prevent contractual arrangements from being disqualified from the exception by failures to reimburse de minimis costs. Therefore the SVTDG requests the exception require the CM be "reimbursed for, or provided with, all <u>substantial</u> [or <u>significant</u> or material] materials, labor, and overhead costs related to fulfilling the contract." This will help avoid disputes over minor items without changing the substance of the requirement.

Comments on the three requested areas are set forth below.

a. The rationale for the proposed exception

The proposed exception is necessary because it would permit a § 199 deduction in contract manufacturing situations in which the CM is paid on a cost-plus basis. In these situations it's typically unlikely the CM would have the BBO. The opportunity to profit from the property in question is a key BBO factor.[10] If the CM is paid on a cost-plus basis, the principal likely has the greater opportunity to profit from the property, and the principal will therefore often have the BBO. Cost-plus arrangements thus are especially likely to result in no party being able to claim a § 199 deduction, because the proposed rule (absent the cost-plus exception) denies the principal a § 199 deduction and the CM is unlikely to have DPGR. The cost-plus exception is therefore necessary to permit a deduction to the principal for the qualifying activity consistent with the purposes of § 199.

b. Administering the proposed exception

The proposed exception should be administrable. Regulations could require principals claiming a § 199 deduction via the proposed cost-plus exception to file statements certifying that their contracts meet the listed criteria. The principal could list each contract manufacturing arrangement under which it is claiming a deduction and certify that the relevant contracts provide for reimbursement of the relevant costs and an allowance for profit. The IRS could then on audit examine these contracts to verify the certifications.

The regulations should permit the criteria of the proposed cost-plus exception be met in substance. That is, even if a contract with a CM isn't drafted using "cost-plus" language, if the contract provides economically for the reimbursement of the specified costs and an additional payment for the allowance for a profit, it should fall within the proposed cost-plus exception.

c. Preventing two taxpayers from claiming the deduction

The proposed exception will prevent two taxpayers from claiming a § 199 deduction for the qualifying activity. As part of its statement certifying the contract meets the listed criteria, the principal could include an agreement by the CM to not seek a § 199 deduction for the qualifying activity. This could be done in a similar manner to the most recent Industry Director

[10] *See, e.g.*, *Illinois Power Co. v. Commissioner*, 87 T.C. 1417, 1436 (1986), *acq. in result only* 1990-2 C.B. 1 ("A significant factor to be used in determining ownership of property is the extent to which the taxpayer has potential for profit or loss as a result of holding the property."); *Grodt & McKay Realty v. Comm'r*, 77 T.C. 1221, 1242–43 (1981).

Directive on § 199, LB&I Control No. LB&I-04-1013-008 (Oct. 29, 2013), which requires the counterparty to agree it won't claim a deduction.

d. Use of cost-plus contracts in practice

The preamble to the proposed regulations states, "The Treasury Department and the IRS are uncertain regarding the extent to which such fully cost-plus or cost-reimbursable contracts are in fact used in practice." Although the SVTDG also isn't certain as to the extent of such contracts, the SVTDG is aware such contracts exist. Based on the extensive experience of SVTDG members (both as principals and CMs) in contract manufacturing, most, if not all, contract manufacturing arrangements are in economic effect "cost-plus" or "cost-reimbursable contracts" in which the CM is providing manufacturing and manufacturing-related services to the principal, with the CM's pricing reflecting its best estimate of the price necessary to cover its costs of providing such services with an allowance for a profit. The proposed exception would therefore be welcome and useful.

C. The temporary rule on W-2 wage limitations in the context of acquisitions and dispositions is welcome and sensible

Subsection 199(b) limits a taxpayer's deduction from its domestic production activities to 50 percent of its W-2 wages paid during the taxable year. If an acquisition or disposition occurs during the taxable year, the proposed rule (and the temporary rule at § 1.199-2T(c)) provides for the allocation of W-2 wages between multiple taxpayers based on the period during which employees of the acquired or disposed of trade or business were employed by the taxpayer. The proposed and temporary rule also treats as W-2 wages those wages paid to employees in a short taxable year that doesn't include the end of a calendar year. There's no good policy reason for denying a § 199 deduction to a company just because it has no calendar-year-end W-2 wages because it's acquired. The proposed and temporary rule is thus a sensible and practicable application of the W-2 wage limitation in the context of acquisitions and dispositions.

D. Current *Example 5* of § 1.199-3(e)(5) should be removed from the final regulations; testing per se shouldn't be excluded as an MPGE activity

Paragraph 1.199-3(e)(1) defines MPGE to <u>include</u> "developing, improving, and creating QPP . . . ." Although no all-encompassing definition is given, what constitutes MPGE is subject to carve-outs in §§ 1.199-3(e)(2) and (3) for packaging, repackaging, labeling, minor assembly, and installation of QPP <u>if no other</u> MPGE activity occurs. There are no other exceptions. All activities described in § 1.199-3(e)(1)—and presumably others, as the list isn't exhaustive—should be considered when determining if a taxpayer MPGE QPP.

Example 5 of § 1.199-3(e)(5) gives no guidance on how to determine if activities performed by a taxpayer are MPGE. The example begins with the conclusory statement "Z

MPGE QPP within the United States. The following activities are performed by Z as part of the MPGE . . . ."[11] The phrase "as part of" implies some MPGE activity occurred other than the activities listed, but such other activities aren't described. No guidance is given as to what activity is sufficient on these facts to constitute MPGE.

Example 5 concludes the listed activities are MPGE activities "[b]ecause Z MPGE the QPP . . . ." The activities listed, however, aren't limited to packaging, repackaging, labelling, minor assembly, and installation. *Example 5* therefore appears to augment the list of activities (i.e., packaging, repackaging, labeling, minor assembly, and installation) that don't, alone, constitute MPGE. This isn't explicit, however, and it's unclear whether there are other activities that don't, alone, constitute MPGE. *Example 5* is confusing as to what activities are MPGE, and will undoubtedly lead to disputes and wasted IRS and taxpayer resources.

The activities listed in *Example 5* (i.e., "materials analysis and selection, subcontractor inspections and qualifications, testing of component parts, assisting customers in their review and approval of the QPP, routine production inspections, product documentation, [and] diagnosis and correction of system failure") should constitute MPGE under the definition in § 1.199-3(e)(1). These activities could each play a significant role in "developing, improving, and creating QPP."[12] These activities aren't carved out from what constitutes MPGE activities. These activities should therefore be considered in determining if a taxpayer MPGE QPP even if the taxpayer conducts no other MPGE activity, but *Example 5* doesn't say how—or if—these activities are considered. *Example 5* should be removed.

Treasury and the IRS propose adding to the end of *Example 5* the sentence "[i]f Z did not MPGE the QPP, then these activities, such as testing of component parts, performed by Z are not the MPGE of QPP." In trying to justify this addition, the preamble states "[t]he Treasury Department and the IRS disagree that testing activities, alone, qualify as an MPGE activity."[13] This blanket rejection of testing as an MPGE activity is unprincipled.

Testing of component parts can be of a fundamentally different character and importance than other activities carved out from MPGE (i.e., packaging, repackaging, labeling, minor assembly, and installation). Testing of component parts can be a major part of the design and manufacturing process. Product testing—particularly in the high tech industry—can cost as much, and take as much time, as assembling the product. Testing often involves many engineers and manufacturing specialists devoting considerable time and effort. Testing can involve development and use of sophisticated, extensive software. The blanket exclusion of testing as an MPGE activity blindly downplays the role of product testing in the manufacturing process.

---

11 § 1.199-3(e)(5) *Example 5* (emphasis added).

12 § 1.199-3(e)(1).

13 80 Fed. Reg. at 51982.

Paragraph 1.199-3(g)(1) requires QPP to be MPGE in whole or in significant part by the taxpayer. For this purpose, § 1.199-3(g)(2) applies an all-facts-and-circumstances test to determine if the "MPGE of the QPP by the taxpayer . . . is substantial in nature . . . ." If the taxpayer's aggregate activities aren't sufficiently extensive or important, they may fail the "substantial in nature" test. A blanket rule against specific types of activity is unnecessary and unreasonably harsh. The all-facts-and-circumstances test under § 1.199-3(g)(2) can be applied in an industry-targeted manner. Activities that are minor in one industry might be significant in another.

Appendix—SVTDG Membership

Accenture
Acxiom Corporation
Adobe Systems, Inc.
Advanced Micro Devices, Inc.
Agilent Technologies, Inc.
Altera Corporation
Amazon.com
Apple Inc.
Applied Materials, Inc.
Autodesk
Avago Technologies
BMC Software
Broadcom Corporation
Brocade Communications Systems , Inc.
Cadence Design Systems, Inc.
Chegg, Inc.
Cisco Systems, Inc.
Cypress Semiconductor
Dolby Laboratories, Inc.
Dropbox Inc.
eBay, Inc.
Electronic Arts
EMC Corporation
Expedia, Inc.
Facebook, Inc.
FireEye, Inc.
Fitbit, Inc.
Flextronics
Fortinet
Genentech, Inc.
Genesys
Genomic Health, Inc.
Gilead Sciences, Inc.
GitHub
GLOBALFOUNDRIES
GlobalLogic, Inc.
Google, Inc.
GoPro, Inc.
Groupon
Hewlett-Packard Company
Ingram Micro
Integrated Device Technology, Inc.
Intel Corporation
Intuit, Inc.
Intuitive Surgical
KLA-Tencor Corporation
Lam Research Corporation
LinkedIn Corporation
Marvell Semiconductor, Inc.
Maxim Integrated
Mentor Graphics
Microsemi Corporation
Microsoft Corporation
NetApp, Inc.
Netflix, Inc.
Oracle Corporation
Palo Alto Networks, Inc.
Pandora Media, Inc.
PayPal Holdings, Inc.
Pivotal Software, Inc.
Plantronics, Inc.
Qualcomm, Inc.
Rovi Corporation
salesforce.com
SanDisk Corporation
Sanmina Corporation
SAP
Seagate Technology
ServiceNow, Inc.
Symantec Corporation
Synopsys, Inc.
Tesla Motors, Inc.
The Cooper Companies
The Walt Disney Company
Theravance Biopharma
Trimble
Twitter, Inc.
Uber Technologies
Visa
VMware Corporation
Yahoo!
Yelp, Inc.