The Section 199 Production Activities Deduction: Background and Analysis

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Summary

In 2004, Congress added the Section 199 domestic production activities deduction to the Internal Revenue Code (IRC). The deduction was intended to achieve a number of policy goals, including compensating for repeal of the extraterritorial income (ETI) export-subsidy provisions, supporting the domestic manufacturing sector, and reducing effective corporate tax rates.

Under current law, qualified activities are eligible for a deduction equal to 9% of the lesser of taxable income derived from qualified production activities, or taxable income. Eligible income includes that derived from the production or property that was manufactured, produced, grown, or extracted within the United States. Electricity, natural gas, and potable water production is also eligible, as is film production. Domestic construction projects, as well as engineering and architectural services associated with such projects, also qualify. Overall, roughly one-third of corporate activity qualifies for the deduction.

In 2008, 66% of corporate claims of the Section 199 deduction were attributable to the manufacturing sector. Another 12% of the value of corporate claims came from the information sector, while 7% were attributable to the mining sector. Other large sectors of the economy, such as finance and insurance as well as wholesale and retail trade, had few Section 199 claims, relative to their contribution towards economic activity. In practice, the Section 199 deduction reduces corporate tax rates for certain selected industries.

Providing a tax break for certain industries can distort the allocation of capital in the economy, reducing economic efficiency and total economic output. Economic efficiency could be enhanced by repealing the Section 199 deduction and using the additional revenues to offset the cost of reducing corporate tax rates. Repealing the Section 199 deduction could allow for a revenue-neutral corporate tax rate reduction of an estimated 1.2 percentage points.

For companies currently claiming the Section 199 deduction, repeal of the deduction in exchange for a reduced corporate tax rate could lead to increased effective tax rates. Under current law, activities eligible for the deduction receive a tax break equal to 3.15 percentage points. Further, the deduction can currently be claimed by pass through entities, including S corporations and partnerships, that would not benefit from a reduction in the corporate tax rate.

Repeal of corporate tax expenditures, which could include the Section 199 deduction, has been part of the tax reform proposals put forth by the Fiscal Commission, Debt Reduction Task Force, and Gang of Six. The Obama Administration's FY2013 Budget proposes to repeal the Section 199 deduction for oil and gas related income, using the added revenues to double the deduction for advanced technology manufacturing activities. The President's framework for business tax reform also proposes modifications to the Section 199 deduction.

Repeal of the Section 199 deduction for certain activities has been considered by the 112th Congress. The Senate voted not to advance legislation to repeal the Section 199 deduction for large oil and gas companies (S. 940). Repealing the Section 199 deduction for the oil and gas sector, or for certain firms in the sector, might help to eliminate tax-induced investment distortions caused by the deduction for those sectors. The deduction would continue to distort economic activity for sectors that are still eligible. Given the inefficiencies associated with the Section 199 deduction, repeal could be an economic efficiency enhancing component of a base-broadening, rate-reducing, corporate tax reform.

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The Section 199 deduction reduces tax rates on certain types of activities, primarily domestic manufacturing activities.[1] In practice, the majority of the tax benefits associated with this provision flow to the manufacturing, mining, and construction sectors. In recent months, a consensus has formed around the need for corporate tax reform. Many economists and policymakers believe that corporate tax reform should result in a tax code with a broad base and low rates that help promote economic activity and growth. Arguably, provisions such as the Section 199 deduction that favor certain economic sectors may be inconsistent with this broad base, low rate objective.

The Section 199 deduction was enacted in 2004 to address a number of policy concerns. In part, the deduction was designed to compensate for the repeal of the extraterritorial income (ETI) provision that had been found to be a prohibited export subsidy by the World Trade Organization (WTO). The deduction was also designed to support the domestic manufacturing sector and reduce effective corporate tax rates. As adopted, the definition of eligible domestic production activities extends beyond the manufacturing sector, reducing effective tax rates across a number of economic sectors.

From an economic perspective, providing a deduction for selected domestic manufacturing activities is less efficient than an across-the-board cut in tax rates. By allowing only certain sectors to qualify for this deduction, the tax code creates an added incentive for capital investment in activities that would have produced lower pre-tax rates of return. This incentive distorts the allocation of capital. Targeted tax incentives may be inefficient as they can drive capital away from its most productive use, reducing overall economic output. Such efficiency concerns are central to economic arguments in support of a broader tax base, with lower tax rates.

Repeal of the Section 199 production activities deduction has been proposed as part of tax reform. Recently, both the Fiscal Commission and the Debt Reduction Task Force have recommended eliminating Section 199, along with most corporate tax expenditures, in exchange for a reduced corporate tax rate.[2] The Tax Rate Reduction and Tax Reform Act of 2007 (H.R. 3970) introduced in the 110th Congress also proposed eliminating various corporate tax expenditures as part of corporate tax reform that would result in lower tax rates.[3] As Congress looks at options for reducing the corporate tax rate, possibly such that the reduction is revenue-neutral, eliminating the production activities deduction might be considered. It has been estimated that eliminating the deduction alone would allow for approximately a 1.2 percentage point reduction in the corporate tax rate.[4]

A targeted repeal or reform of the Section 199 deduction has also been considered. One common theme is to evaluate the eligibility of certain types of activities, notably those related to oil and gas. Already, the deduction for oil and gas is limited. Since 2007, Congress has voted numerous times on measures that would repeal the Section 199 deduction for oil and gas related activities. Some of these votes would have only repealed the deduction for major integrated oil companies,

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[1] Section 199 refers to the deduction's section in the Internal Revenue Code (IRC).

[2] For additional information on tax policy options for deficit reduction, see CRS Report R41641, *Reducing the Budget Deficit: Tax Policy Options*, by (name redacted).

[3] For additional information, see CRS Report RL34249, *The Tax Reduction and Reform Act of 2007: An Overview*, by (name redacted).

[4] See CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by (name re dacted).

while other legislation has sought to remove all oil and gas related activities from the list of qualifying activities. The Obama Administration has proposed eliminating the Section 199 deduction for oil and gas in FY2010, FY2011, and FY2012 Budget Proposals. Eliminating the Section 199 deduction for oil and gas has been part of the Administration's broader strategy to phase-out federal financial support for fossil fuels.[5]

The President's FY2013 Budget also proposes changes to the Section 199 production activities deduction. Under the President's proposal, the deduction could no longer be claimed for income derived from the production of oil and gas, the production of coal and other hard mineral fossil fuels, and certain other "nonmanufacturing" activities. The revenue generated from these changes would be used to increase the deduction percentage for certain "advanced technology" manufacturing activities.[6]

The President's framework for business tax reform, released February 22, 2012, also proposes to increase the production activities deduction for manufacturing activities. Further, the proposal would provide a larger deduction for unspecified "advanced manufacturing" activities.[7]

Currently, Section 199 allows a deduction equal to 9% of taxable income derived from qualified production activities. Qualified production activities are defined to include manufacturing, mining, electricity and water production, film production, and domestic construction. For oil and gas related activities, the deduction is permanently limited to 6%. Across all sectors, the deduction cannot exceed 50% of W-2 wages paid by the taxpayer for qualifying activities. This report provides a legislative history of the Section 199 deduction, details on how the production works in practice, an economic evaluation of the deduction, along with analysis of the various economic sectors benefitting from the provision. A number of policy options related to the Section 199 deduction conclude this report.

Legislative History and Background

The Section 199 domestic production activities deduction was added to the Internal Revenue Code (IRC) as part of the American Jobs Creation Act of 2004 (AJCA; P.L. 108-357). The Section 199 deduction was designed, in part, to replace an incentive that had been found to be a prohibited export subsidy by the World Trade Organization (WTO).[8]

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[5] For additional details on the tax proposals in the President's FY2012 Budget Proposal, see Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, Washington, DC, February 2011, http://www.treas.gov/offices/tax-policy/library/greenbk12.pdf.

[6] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, Washington, DC, February 2012, p. 30, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

[7] See The White House and the Department of the Treasury, *The President's Framework for Business Tax Reform*, Washington, DC, February 2012, http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf.

[8] The Conference Report on AJCA noted that AJCA was "crafted to repeal an export benefit that was deemed inconsistent with obligations of the United State under the Agreement on Subsidies and Countervailing Measures and other international trade agreements." The report went on to state that the AJCA "replaces" export tax relief with a reduced tax rate for U.S.-based manufacturers. See U.S. Congress, House of Representatives, *American Jobs Creation Act of 2004*, Conference Report to Accompany H.R. 4520, 108th Cong., 2nd sess., October 7, 2004, Report 108-755, p. 275.

From 1971 through 2000, the U.S. attempted to promote exports through a variety of tax benefits that were found to violate export-subsidy agreements under the General Agreement on Tariffs and Trade (GATT) and later the World Trade Organization (WTO).[9] The extraterritorial income (ETI) provisions were the last in this series of export-related tax benefits.[10] The ETI provisions exempted certain export income and a limited amount of income from foreign operations from U.S. tax.

A Brief History of U.S. Export Subsidies

In 1971, the Domestic International Sales Corporation (DISC) provisions were enacted as part of a broader economic package designed to address a number of perceived economic problems, including a deteriorating balance of payments.[11] DISC was originally proposed during an era of fixed exchange rates, as a policy option for improving the balance of payments, among other goals. The DISC provisions created an incentive for U.S. multinationals to produce domestically for export, rather than locating production abroad.

The provisions allowed U.S.-based manufacturing firms to set up a DISC subsidiary, through which it sold exports. Export income could then be allocated to this DISC. DISCs as entities were tax-exempt. Income allocated to the DISC could be deferred and would not be subject to tax until it was remitted to the U.S. parent corporation. In effect, the DISC provisions allowed firms to indefinitely defer taxes on an estimated 16% to 33% of their export income.[12]

Several European countries objected to the DISC provisions, complaining that they constituted a prohibited export subsidy under the General Agreement on Tariffs and Grade (GATT, predecessor to the WTO). In 1984, the U.S. replaced the DISC provisions with Foreign Sales Corporation (FSC) provisions, in an attempt to achieve GATT legality.

FSCs were similar to DISCs, in that both allowed exporters to obtain tax benefits by selling exports through tax-preferred subsidiary corporations. In contrast to DISCs, FSCs were not allowed to be located in the United States, and were required to conduct certain management activities abroad. Under the FSC provisions, the total tax exemption was an estimated 15% to 30% of export income, slightly less that what had been available under DISC.[13] Ultimately, the FSC provisions were found to violate export-subsidy obligations under the WTO Agreement on Subsidies and Countervailing Measures. In 2000, Congress moved to repeal FSC, establishing the ETI provisions as a replacement.[14]

The ETI provisions attempted to address WTO-legality concerns by providing a tax benefit that included exports, but was not “export contingent.” The ETI provisions exempted extraterritorial income from U.S. tax. Extraterritorial income was defined to provide an exemption for certain export income and a limited amount of income from foreign operations. Despite the attempt to make the ETI provisions not export contingent, the WTO still found that the ETI provisions were, in practice, an export subsidy. Congress moved to phase out the ETI provisions under AJCA and ultimately repealed the transition rules, fully eliminating the ETI provisions, as part of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA; P.L. 109-222).

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[9] There are other provisions in the tax code that may be viewed as export subsidies. For example, the tax code’s rules governing the source of inventory sales serve to increase the after-tax return on investment in exporting (i.e., subsidize exports). The so-called “title passage” rule effectively allows companies to source their inventory sales abroad. For more information, see U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, prepared by Congressional Research Service, 111th Cong., December 2010, S. Prt. 111-58, pp. 57-60.

[10] For a concise history of U.S. export tax subsidies, see the text box, “A Brief History of U.S. Export Subsidies.” A more complete history of export-related tax benefits can be found in CRS Report RL31660, *A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy*.

[11] See the Revenue Act of 1971 (P.L. 92-178). The DISC provisions went into effect on January 1, 1972.

[12] See CRS Report RL31660, *A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy*.

[13] See CRS Report RL31660, *A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax-Benefit Controversy*.

[14] See the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106-519).

There were other policy motivations behind the Section 199 deduction, in addition to compensating for ETI repeal. Congress noted that the Section 199 deduction helped reduce U.S. corporate tax rates, address challenges imposed on the manufacturing sector during the economic slowdown of the early 2000s, and promote international competitiveness.[15]

As enacted, the estimated revenue loss over 10 years associated with enactment of the deduction was more than 1.5 times the revenues gained from repealing ETI.[16] Over the 2005 through 2014 budget window, repeal of the ETI provisions were estimated to generate $49.2 billion in additional revenues. Over the same time period, revenue losses associated with enactment of Section 199 were estimated at $76.5 billion, for a net revenue loss of $27.3 billion.

Since being enacted in 2004, the Section 199 deduction has undergone a number of minor modifications. TIPRA clarified that wages for the purpose of the deduction limit were those relating to domestic production activities. The Tax Relief and Healthcare Act of 2006 (P.L. 109-432) added the benefit for Puerto Rico, on a temporary basis. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the benefits for Puerto Rico through 2011.

Additional changes were made to the Section 199 deduction as part of the Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343). Under EESA, oil-related qualifying production activities, including but not limited to oil and gas extraction, were limited to a 6% deduction for tax years starting after 2009.

The Section 199 deduction was also modified under EESA to take into consideration domestic film industry operations.[17] Specifically, W-2 wage limitation restrictions were modified for the film industry, as was the application of the Section 199 deduction to partnerships and S corporations in the film industry.

Legislative Efforts to Modify the Section 199 Deduction for Oil and Gas

110th Congress

Early in the 110th Congress, Speaker Pelosi announced the "Energy Independence Day" initiative (H.R. 3221), which included several energy-related bills. The energy tax bill, the Renewable Energy and Energy Conservation Tax Act of (H.R. 2776), contained a provision that would have repealed the Section 199 deduction for oil and gas. The Senate-Finance-Committee-approved energy tax package would have prevented major integrated oil companies from claiming the Section 199 deduction. However, the Senate failed to invoke cloture on the broader package of energy bills when the tax title was included. Ultimately, the Senate-passed version of the comprehensive energy legislation (H.R. 6) did not include a repeal of the Section 199 deduction for oil and gas.[18] The compromise energy bill that was ultimately signed into law on December 19, 2007, the Energy Independence and Security Act of 2007 (P.L. 110-140), did not modify the Section 199 deduction for oil and gas.

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[15] See U.S. Congress, House of Representatives, *American Jobs Creation Act of 2004*, Conference Report to Accompany H.R. 4520, 108th Cong., 2nd sess., October 7, 2004, Report 108-755, p. 275.

[16] See U.S. Congress, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, committee print, 108th Cong., May 2005, JCS-5-05, p. 546.

[17] Congress believed domestic film production to be important to the U.S. economy. See U.S. Congress, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress*, committee print, 110th Cong., March 2009, JCS-1-09, pp. 447-449.

[18] The Bush Administration released a statement on December 6, 2007, opposing repeal of the Section 199 deduction for the oil and gas sector. See The White House, "Statement of Administration Policy: H.R. 6—Energy Independence and Security Act of 2007," press release, December 6, 2007.

Legislative efforts to repeal the Section 199 deduction for oil and gas continued in 2008. The Comprehensive American Energy Security and Consumer Protection Act (H.R. 6899) proposed to repeal the Section 199 deduction for major integrated oil companies, and to restrict the deduction to 6% for oil and gas related activities.[19] The legislation also sought to repeal the deduction for state-owned oil companies.[20] Legislation containing this provision was approved by the House on September 16, 2008. Similar legislation was offered in the Senate (S. 3478). Ultimately, provisions limiting the Section 199 deduction to 6% for oil related activities were approved by the Senate as part of a package combining financial sector rescue with tax extenders.[21] A limitation of the Section 199 production activities deduction for oil-related activities was signed into law as part of the Energy Tax Title in the Emergency Economic Stabilization Act (EESA; P.L. 110-343).

111th Congress

During the 111th Congress, the Senate considered measures that would have repealed the Section 199 deduction for oil and gas. S.Amdt. 4318 to the American Jobs and Closing Tax Loopholes Act (H.R. 4213) would have repealed the Section 199 deduction for oil and gas. This measure was defeated on June 15, 2010. During 2010, the Senate also voted on a measure that would have eliminated the Section 199 deduction for major integrated oil companies, as part of an amendment to provide exemptions from the 1099 information reporting requirements (S.Amdt. 4595 to H.R. 5297).[22] The amendment was withdrawn on September 15, 2010 after cloture was not invoked.

112th Congress

Early in the 112th Congress, legislation seeking to repeal, among other oil and gas related tax provisions, the Section 199 deduction for oil and gas was again considered. Specifically, the Close Big Oil Tax Loopholes Act (S. 940) seeks to repeal the Section 199 deduction, and other oil and gas related tax provisions, for major integrated oil companies. On May 17, 2011, the Senate failed to invoke cloture on S. 940.

The Deduction: Applying the Deduction to Qualified Activities

The Section 199 production activities deduction, as enacted in 2004, was phased in such that the full deduction rate of 9% was reached starting in 2010. During 2005 and 2006, eligible taxpayers could claim a tax deduction equal to 3% of the lesser of taxable income or qualified production activities income. For tax years 2007, 2008, and 2009 the deduction rate was 6%.

The production activities deduction allows taxpayers a deduction based on the lesser of taxable income derived from qualified production activities (qualified production activity income; QPAI) or taxable income.[23] A taxpayer's QPAI is equal to the taxpayer's domestic production gross receipts (DPGR), reduced by (1) the cost of goods sold that is allocable to those receipts; and (2) other deductions, expenses, and losses that are properly allocable to those receipts.

Eligible income includes that derived from production property that was manufactured, produced, grown, or extracted within the United States. Electricity, natural gas, and potable water

(...continued)

[19] In 2008, the deduction was set at 6% for all eligible activities, but was scheduled to increase to 9% after 2009.

[20] This provision was intended to repeal the Section 199 deduction for foreign-owned oil companies, such as CITGO, which is owned by the government of Venezuela.

[21] H.R. 1424 passed a Senate vote on October 1, 2008.

[22] For additional background, see CRS Report R41400, *Economic Analysis of the Enhanced Form 1099 Information Reporting Requirements*, by (name redacted) and CRS Report R41782, *1099 Information Reporting Requirements and Penalties: Recent Legislative Activity*, by (name redacted) and (name redacted).

[23] For individual taxpayers, the deduction is limited to the lesser of QPAI or adjusted gross income (AGI).

production is also eligible. As noted above, film production also qualifies. Construction performed within the United States may also qualify for the deduction, as can engineering and architectural services associated with domestic construction projects. Overall, roughly one-third of corporate activity qualifies for the deduction.[24]

When Section 199 was added to the code in 2004, the Treasury was granted broad authority to prescribe regulations necessary to carry out the purposes of the legislation. The Treasury defined qualified activities that were "manufactured, produced, grown, or extracted" to include minerals mining and refining activities.[25] Oil refining is explicitly used as an example in the Treasury regulations as a qualified activity.[26] The Treasury regulations also clarified that constriction activities related to drilling of oil and gas wells were qualified activities for the Section 199 deduction.

The deduction is permanently limited to 6% for oil-related qualified production activities.[27] For the purposes of limiting the Section 199 deduction, EESA defined oil-related production activities as being related to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof. A primary product from oil includes crude oil, and all products derived from the destructive distillation of crude oil, such as motor fuel.

The deduction cannot exceed 50% of the W-2 wages paid by the taxpayer during the year. The wage limitation effectively prevents sole proprietorships without employees from claiming the credit. Only wages allocable to qualifying domestic production activities qualify. Limiting the deduction according to wages paid for qualifying domestic production activities helps ensure that taxpayers claiming the deduction are paying wages to domestic employees.

The Section 199 production activities deduction serves to reduce the effective tax rate—the actual rate of taxes paid relative to income—on qualified activities. Generally, tax liability is calculated as follows:

$$\text{Taxes} = [(\text{Income} - \text{Expenses})(1 - p) \times t] - \text{Tax Credits},$$

where t is the statutory tax rate and p is the production activities deduction.

For businesses, the primary component of income is revenues from the sale of goods and services. Other income sources include investment income, royalties, rents, and capital gains.

Once income has been determined, expenses allowed by the IRC are deducted.[28] Businesses can deduct expenses, including salaries and wages, purchased materials and inputs, advertising costs,

[24] In 2008, corporate income subject to tax (excluding S corporations, REITs, and RICs) was nearly $977 billion. One-third of this figure is $326 billion. In 2006, a deduction rate of 6% implies roughly $19 billion in deductions would have been claimed. Actual deductions claimed by corporations paying the corporate income tax were more than $18 billion in 2008.

[25] U.S. Congress, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress*, committee print, 110th Cong., March 2009, JCS-1-09, pp. 354-355.

[26] *Ibid.*

[27] Oil-related production activities include the production, refining, processing, transportation of oil and gas.

[28] Deductions reduce tax liability according to the corporation's marginal tax rate. For example, if a corporation in the 35% tax bracket has a qualifying deduction of $100,000, the corporation's tax liability is reduced by $35,000 (= $100,000 × 35%).

charitable contributions, insurance premiums, legal fees, and various other items. Interest payments are also deductible, as are deductions for depreciation allowances.[29] Theoretically, taxes are levied on profits, rather than gross income.

When the production activities deduction applies, the tax rate is the statutory tax rate (generally, 35%) multiplied by (1-p).[30] For example, when $p = 0.09$, the effective tax rate becomes 31.85% (= 35% × 0.91). When $p = 0.06$, as is currently the case for the oil- and gas-related activities, the effective tax rate becomes 32.9% (=35% × 0.94).

Calculating the Domestic Production Activities Deduction: Examples

The following examples illustrate hypothetical calculations of the Section 199 production activities deduction.

Company 1

Company 1 is a manufacturing corporation operating exclusively within the United States. In 2010, Company 1's activities generated $1 million in QPAI. During 2010, Company 1 paid W-2 wages of $500,000. Company 1 also had a net operation loss (NOL) carry forward of $300,000.

Since Company 1 had a NOL carry forward, taxable income was less than QPAI (taxable income in this case is assumed to be $1 million less the $300,000 NOL carry forward, or $700,000), Applying the 9% deduction rate, Company 1's deduction is $63,000. Since W-2 wages were $500,000 in 2010, Company 1's deduction was not reduced by the wage limitation.

Assuming a corporate tax rate of 35%, this $63,000 deduction reduces Company 1's tax liability by $22,050.

Company 2

Company 2 is a manufacturing company with operations in the United States and abroad. Company 2 generated a total of $1 million in production activities income. One-half of that income, or $500,000, was generated in the United States. Company 2 paid $250,000 in W-2 wages to U.S. workers for domestic production activities.

Applying the 9% deduction rate to Company 2's domestic production activities income, Company 2's deduction is $45,000. Company 2's deduction was not reduced by the wage limitation. If Company 2 had earned all of their manufacturing income in the U.S., the deduction would have been twice as large.

Assuming a corporate tax rate of 35%, this $45,000 deduction reduces Company 2's tax liability by $15,750.

Company 3

Company 3 is a U.S. firm engaged in oil related qualified production activities. For 2010, Company 3's activities generated $500,000 in oil related QPAI. During 2010, Company 3 paid W-2 wages of $50,000.

Since Company 3's QPAI is from oil related activities, Company 3's deduction rate in limited to 6%. The 50% of W-2 wages limitation limits Company 3's Section 199 deduction to $25,000 (50% of Company 3's $50,000 W-2 wages paid). In the absence of the W-2 wage limitation, Company 3's deduction would have been $30,000 (6% of $500,000 in QPAI).

Assuming a corporate tax rate of 35%, this $25,000 deduction reduces Company 3's tax liability by $8,750.

[29] Depreciation allowances account for the decline in value of tangible capital. When corporations purchase capital assets, such as buildings and equipment, it is expected that these capital assets will be used in the production process for many years. The tax code requires that businesses capitalize such investments, and take depreciation deductions over time. Oftentimes, depreciation deductions are allowed at a rate that approximates the rate at which the capital investment loses value. Other times, depreciation allowances are accelerated, providing additional deductions early-on, increasing the value of the stream of deductions to the taxpayer. Accelerated depreciation allowances can compensate taxpayers for depreciation systems that are not indexed to inflation, and thus do not compensate taxpayers for price changes over time. Thus, when assessing the value of depreciation allowances, a present value methodology should be employed.

[30] In calculating the tax liability for activities that do not qualify for the Section 199 deduction, $p = 0$.

Tax Expenditure Estimates

During 2012, the production activities deduction is expected to result in $13.4 billion in federal revenues losses ($9.3 billion for corporations, $4.1 billion for individuals) (see **Table 1).** Estimated revenue losses have generally increased since the provision was first enacted in 2005. Much of the increase over this period can be explained by the increased deduction rate, which was phased in to reach the full 9% rate for most eligible producers by 2010.

Between 2005 and 2011, JCT estimates suggest that approximately 75% of the revenue losses resulting from the Section 199 deduction are attributable to the corporate sector. The remaining revenue losses stem from deductions taken by S corporations, partnerships, and sole proprietorships.[31] When the Section 199 deduction was enacted in 2004, JCT estimated that in 2005, 75% of the associated revenue losses would be attributable to C corporations, 12% associated with S corporations and cooperatives, 9% with partnerships, and 4% with sole proprietorships.[32] In the out years (beyond 2011), JCT predicts that an increasing proportion of Section 199 revenue losses will come from the non-corporate sector (see **Table 1**).[33]

Table 1. Production Activity Deduction Tax Expenditures

billions of dollars

	Deduction Rate										
	3%		6%			9%[a]					
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Corporate	1.8	2.7	3.9	5.5	5.0	7.0	8.9	9.3	9.7	10.3	10.8
Non-Corporate	0.6	0.9	1.3	1.8	1.2	2.4	3.4	4.1	4.7	5.3	5.6
Total	**2.4**	**3.6**	**5.2**	**7.3**	**6.2**	**9.4**	**12.3**	**13.4**	**14.4**	**15.6**	**16.4**

Source: Joint Committee on Taxation (JCT), Tax Expenditure Estimates, Various Editions, available at http://www.jct.gov/publications.html?func=select&id=5.

Notes: Annual tax expenditure estimates are projections, and reflect estimated rather than actual federal revenue losses.

a. For years after 2009, oil- and gas-related activities are limited to a 6% deduction.

Economic Issues

As the economy continues on what appears likely to be a prolonged recovery following the recent recession, it remains important to continuously evaluate how to make the best use of limited economic resources. For economists, when resources are put to their best use, economic

[31] For additional background on these different types of organizations, see CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by (name redacted).

[32] Letter from George K. Yin, Joint Committee on Taxation, to Mark Prater and Patrick Heck, Senate Finance Committee, Revenue Estimate Request, September 22, 2004.

[33] By 2015, JCT estimates that 66% of Section 199 revenue losses will be attributable to the corporate sector.

efficiency is maximized. The following sections outline the concepts of economic efficiency and discuss the Section 199 deduction in this framework.

Economic Efficiency[34]

Economic efficiency is maximized when resources (capital and labor) are employed in their most productive use. When economic efficiency is maximized, so too is economic output. In a well-functioning free market, the return to various investments should adjust to ensure capital is allocated efficiently. When the return to an investment in one sector of the economy is higher than the return in another, this differential sends a signal that capital is valued more highly in that first sector. Capital will tend to flow out of the low-return sector into the higher-return sector, until the returns to capital across sectors are equalized.

Resource allocation and economic efficiency can be affected by tax policy. Tax policy can be used to enhance economic efficiency when markets fail to direct resources to their most productive uses.[35] Alternatively, tax policy can also reduce economic efficiency. When taxpayers distort resource allocation in response to tax-induced incentives, economic output may not be maximized, as resources are not directed to their most productive uses, reflecting reduced economic efficiency.

The Section 199 production activities deduction increases the after-tax return to particular investments by lowering the effective tax rate in certain industries, and thus may distort the allocation of capital. This effect reduces economic efficiency and total economic output by directing capital away from its most productive use.

Part of the policy rationale behind adopting the Section 199 deduction was to provide support to the manufacturing sector.[36] Specifically, there were concerns regarding the impact of competition from foreign producers on U.S. manufacturers.[37] In practice, however, the decline in manufacturing employment since 2000 can also be explained by increases in productivity.[38] Increased productivity is generally associated with strong economic growth. If increased productivity is the reason behind declines in manufacturing sector employment, tax policies designed to promote manufacturing employment could reduce economic efficiency, as such tax policies are not correcting for a market failure.

The Section 199 deduction, however, could serve to reduce other economic inefficiencies created by the tax code. The tax-favored status of investments financed using debt rather than equity may

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[34] A discussion of economic efficiency issues with the Section 199 production activities deduction can also be found in (name redacted), "The 2004 Corporate Tax Revisions as a Spaghetti Western: Good, Bad, and Ugly," *National Tax Journal*, vol. 58, no. 3 (September 2005), pp. 347-365.

[35] Market failures such as externalities may lead to circumstances under which tax policies can be used to enhance economic efficiency. For example, increasing the tax on activities that generate negative externalities—or indirect costs not reflected in market prices—can reduce the equilibrium amount of the taxed activity, simultaneously enhancing economic efficiency.

[36] See U.S. Congress, House of Representatives, *American Jobs Creation Act of 2004*, Conference Report to Accompany H.R. 4520, 108th Cong., 2nd sess., October 7, 2004, Report 108-755, p. 275.

[37] *Ibid.*

[38] See Congressional Budget Office, *Factors Underlying the Decline in Manufacturing Employment Since 2000*, Economic and Budget Issue Brief, Washington, DC, December 23, 2008.

lead to various economic distortions.[39] The Section 199 deduction, by reducing tax rates in the corporate sector, may help reduce debt-equity distortions. These distortions could also be reduced, however, through reduced corporate tax rates for all sectors, rather than reduced rates provided through a deduction that is only available to certain economic sectors. These distortions could also be reduced by eliminating the preference for debt over equity in the tax code.[40]

Evaluating Economic Efficiency in the Tax Code: The Effective Tax Rate Approach

As discussed above, the Section 199 production activities deduction likely contributes to economic distortions by promoting capital investment in selected industries and activities. One method for evaluating tax-induced economic distortions is to use an effective tax rate approach. Mathematically, an effective tax rate is the

$$\frac{\text{Before Tax Return to Capital - After Tax Return to Capital}}{\text{Before Tax Return to Capital}}.$$

In other words, the effective tax rate is the taxation-induced percentage increase in the pre-tax return to capital. The lower the effective tax rate, the more a specific type of investment is preferred in the tax code. Effective tax rates can be negative, if firms have an incentive to invest more when taxed than in the absence of taxes.

Effective tax rates are influenced by many different provisions in the tax code. As discussed above, a 9% production activities deduction reduces the corporate effective tax rate on qualifying activities from 35% to 31.85%. Varying depreciation rules also lead to differences in effective tax rates across sectors.[41] While a full analysis of effective tax rates is beyond the scope of this report, it is important to note that the Section 199 deduction can create even further distortions in sectors already potentially benefitting from favorable depreciation schedules or various other tax incentives. Moving towards a more neutral taxation of businesses will require consideration and evaluation of the wide array of tax-induced distortions, which often cannot be fully evaluated in isolation.

Deduction Versus Rate Reduction: Firms' Perspective

There are several reasons why the Section 199 production activities deduction may have been structured as a targeted deduction, rather than an across-the-board rate reduction. While an

[39] For further discussion, see Rudd A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, International Monetary Fund, IMF Staff Discussion Note, May 3, 2011.

[40] For additional background, see U.S. Congress, Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt*, committee print, prepared by Joint Committee on Taxation, 112th Cong., July 11, 2011, JCX-41-11.

[41] Generally, within the corporate sector, depreciation schedules tend to generate lower effective tax rates for investments in equipment relative to investments in structures. Bonus depreciation provisions reduce the effective tax rates for investments in equipment even further. For a full analysis of corporate effective tax rates across industrial sectors, see CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by (name redacted) and (name reda cted). This report provides estimates of effective ta x rates across different asset classes with and without the Section 199 production activities deduction.

across-the-board rate reduction may have been a more economically efficient alternative, certain firms may have had various reasons for preferring the deduction as opposed to reduced rates. Industries eligible for the Section 199 deduction would prefer the deduction to a revenue neutral rate cut available to all industries, since the benefit of the deduction is larger for eligible industries. Repealing the Section 199 deduction could generate enough added revenue to reduce corporate tax rates across-the-board by roughly one percentage point. Under current law, the Section 199 deduction reduces effective tax rates by roughly three percentage points for firms eligible for the 9% deduction.

Non-corporate entities also benefit from having Section 199 structured as a deduction rather than having a cut in the corporate tax rate. Non-corporate entities paying taxes in the individual income tax system as pass-through entities are able to benefit from a deduction, while they would not benefit from a corporate rate cut. Repealing the Section 199 deduction to finance a reduced corporate tax rate would likely increase tax liability for non-corporate entities currently able to claim the Section 199 deduction.

Administrative Complexity

The Section 199 deduction and the associated regulations have increased complexity in the tax code. Both taxpayers and the government face an added administrative burden. Taxpayers wanting to claim the deduction must allocate costs and jobs devoted to activities performed in the United States to determine both receipts associated with the qualified activities and associated costs. The complexity associated with determining what qualifies for the deduction may increase the record keeping and accounting burden on firms. Further, given that production activities are tax favored, firms have an incentive to shift profits among divisions, and characterize income as being related to domestic production activities, where possible.[42] This incentive may stress limited enforcement resources for the IRS. To the extent that Section 199 deduction claims are a point of contention, IRS enforcement efforts are allocated here rather than to other areas of the code.

Distribution of Benefits Across Major Industries

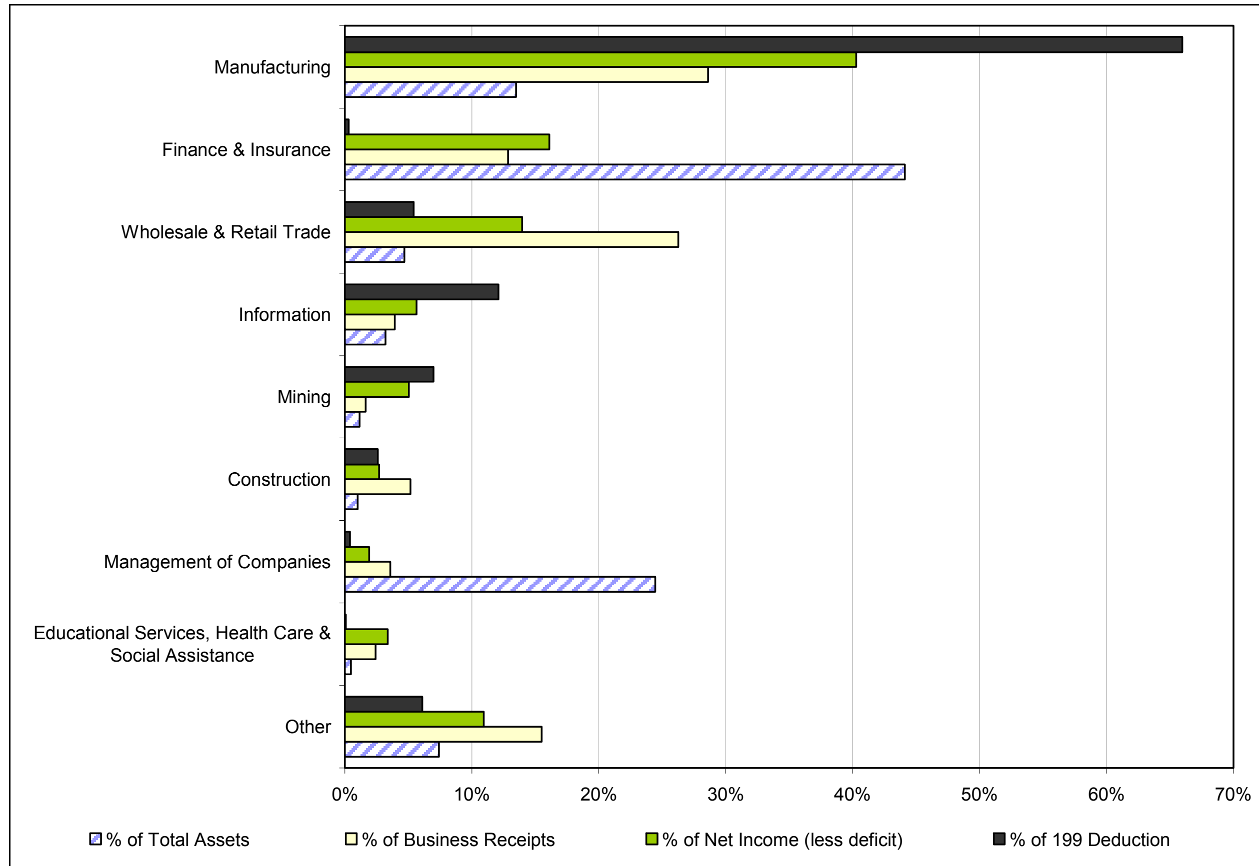
As was noted above, one policy rationale for the Section 199 deduction was to support the domestic manufacturing sector. In practice, the majority of the benefits received by corporations go to those involved in manufacturing (66% in 2008; see **Figure 1**).[43] A number of industries with primary designations other than manufacturing also benefit from the Section 199 deduction.

[42] See Kimberly A. Clausing, *The American Jobs Creation Act of 2004: Creating Jobs for Accountants and Lawyers*, Urban-Brookings Tax Policy Center, Washington, DC, December 2004, http://www.taxpolicycenter.org/UploadedPDF/311122_AmericanJobsAct.pdf.

[43] For analysis of specific companies benefitting from the Section 199 deduction, see Elizabeth Karasmeighan, *Domestic Production Deduction: The Impact of Repeal*, Bloomberg Government, Washington, DC, January 26, 2012.

Figure 1. Distribution of Business Assets, Receipts, and Profits Relative to Distribution of Section 199 Deduction

2008



Source: CRS calculations using data from the 2008 Internal Revenue Service (IRS) Corporate Statistics of Income (SOI), Returns of Active Corporations.

Notes: Other industries include agriculture (including forestry, fishing, and hunting), utilities, transportation & warehousing, real estate & rental leasing, professional services, administrative support, waste management, arts & entertainment, accommodation, food services, and other services. Data on the 199 deduction does not include S corporations, REITs, or RECs. Data on total assets, business receipts, and net income is inclusive of the entire corporate sector (including S corporations).

Figure 1 illustrates the distribution of Section 199 claims made by corporations across industrial sectors, relative to the distribution of total corporate assets, total corporate business receipts, and total corporate profits (net income less deficit) for 2008.[44,45] As noted above, in 2008, 66% of corporate claims of the Section 199 deduction were made by firms in the manufacturing sector.[46] The share of manufacturing claims of the Section 199 deduction are high relative to the size of the manufacturing sector. The manufacturing sector is responsible for generating 40% of corporate profits, 29% of corporate receipts, and holds 13% of corporate assets.[47]

The information and mining sectors' share of Section 199 claims also exceeds their respective shares of corporate profits, corporate receipts, and corporate assets.[48] More than 12% of corporate Section 199 deductions are claimed by firms in the information sector, while this sector is responsible for 6% of corporate profits, 4% of corporate receipts, and 3% of corporate assets. The mining sector claims 7% of corporate Section 199 deductions, while earning 5% of corporate profits, less than 2% of corporate receipts, and holding 1% of corporate assets.

Finance and insurance, and other service-oriented sectors such as educational services, health care, and social assistance, receive little benefit from the Section 199 deduction. While the finance and insurance sector earned 16% of corporate profits, 13% of corporate receipts, and held 44% of corporate assets in 2008, the sector's share of Section 199 deduction claims was 0.3%.[49] Corporate claims of the Section 199 deduction were also small for the education services, health care, and social assistance sectors. The corporate sector of this industry, as measured by profits, receipts, and total assets is also relatively small. As discussed below, these services are often provided by firms outside of the corporate sector.

The volume of legislative activity related to the Section 199 deduction and the oil and gas sector indicates congressional interest in this sector. The IRS SOI data can be used to provide some insight into oil and gas sector deduction claims. While the industry data do not explicitly identify oil- and gas-related activities qualifying for the Section 199 deduction, much of this activity is likely captured in the data for the oil and gas extraction and the petroleum refineries (including integrated) sectors. Note that these data are from 2008, before the oil and gas sector was restricted to the 6% reduced rate.

[44] Business receipts are generally gross operating receipts of the corporation, reduced by the cost of returned goods and allowances. Generally, business receipts include all corporate receipts except investment and incidental income.

[45] **Figure 1** includes data for all active corporations, including C corporations, S corporations, U.S. income tax returns for foreign corporations, insurance corporations, regulated investment companies, and real estate investment trusts (IRS Forms 1120, 1120-F, 1120S, 1120-L, 1120-PC, 1120-RIC, 1120-REIT, and 1120-A). Data on Section 199 claims is only reported by C corporations and not S corporations.

[46] Nearly all Section 199 claims (99.8%) recorded in these data were made on IRS Form 1120, the form used by C corporations. Form 1120S filed by S corporations does not separately identify the Section 199 production activities deduction. Thus, Section 199 deductions claimed by S corporations are not included in **Figure 1**.

[47] Note that the Section 199 deduction is limited to domestic production activities, while profits, receipts, and assets reported by U.S. taxpayers may be associated with foreign activities.

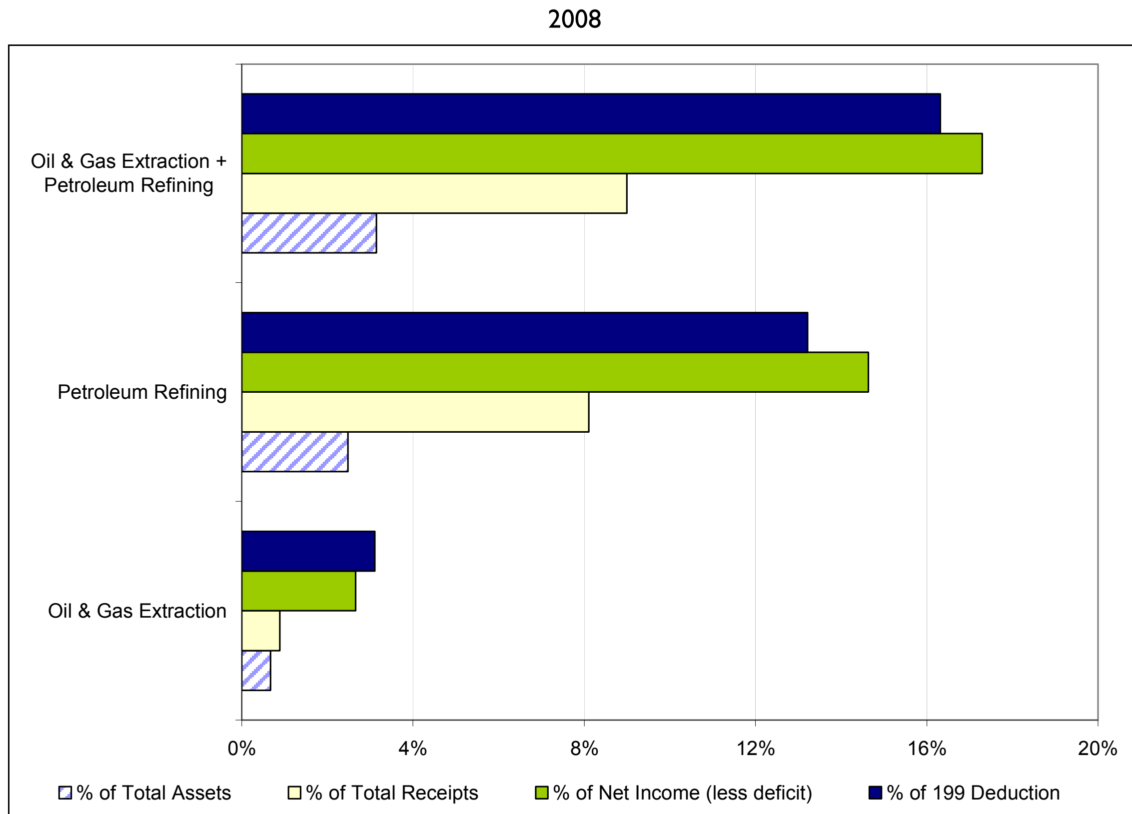
[48] The information sector includes publishing industries, motion picture and sound recording industries, broadcasting, telecommunications, and data processing.

[49] When S corporations are excluded, net income (less deficit), or profits in the finance and insurance as well as the construction sectors are negative. During 2008, negative corporate profits in the finance and insurance sector by firms other than S corporations, REITs, and RICs, reduced overall profits by nearly half.

Of the $18.4 billion in Section 199 deductions claimed in 2008 by C corporations, 3% were claimed by firms classified as being in the oil and gas extracting sector (see **Figure 2**).[50] Another 13% were claimed by petroleum refineries (including integrated petroleum refineries).[51] In the manufacturing and mining sectors as a whole, the share of Section 199 deductions being claimed by the sector exceeded the share of net income (less deficit), or profits, attributable to the sector. The opposite is true for subsectors of oil and gas extraction and petroleum refining. The share of profits attributable to these sectors exceeds the share of Section 199 deductions being claimed by these sectors. The two sectors combined reported 17% of corporate profits, while claiming 16% of Section 199 deductions. As was the case with the manufacturing and mining sectors generally, the share of Section 199 deductions attributable to the oil and gas extracting and petroleum refining sectors is greater than the sector's respective shares of business receipts and corporate assets (see **Figure 1** and **Figure 2**).

Figure 2. Oil and Gas Sector Distribution of Business Assets, Receipts, and Profits Relative to Distribution of Section 199 Deduction

2008



Source: CRS graphic using data from Internal Revenue Service (IRS), Statistics of Income (SOI), Corporate Source Book.

Notes: Data on the 199 deduction does not include S corporations, REITs, or RECs. Data on total assets, business receipts, and net income is inclusive of the entire corporate sector (including S corporations).

[50] In **Figure 1** above, oil and gas extraction is included in the mining sector.

[51] In **Figure 1** above, petroleum refineries are included in the manufacturing sector.

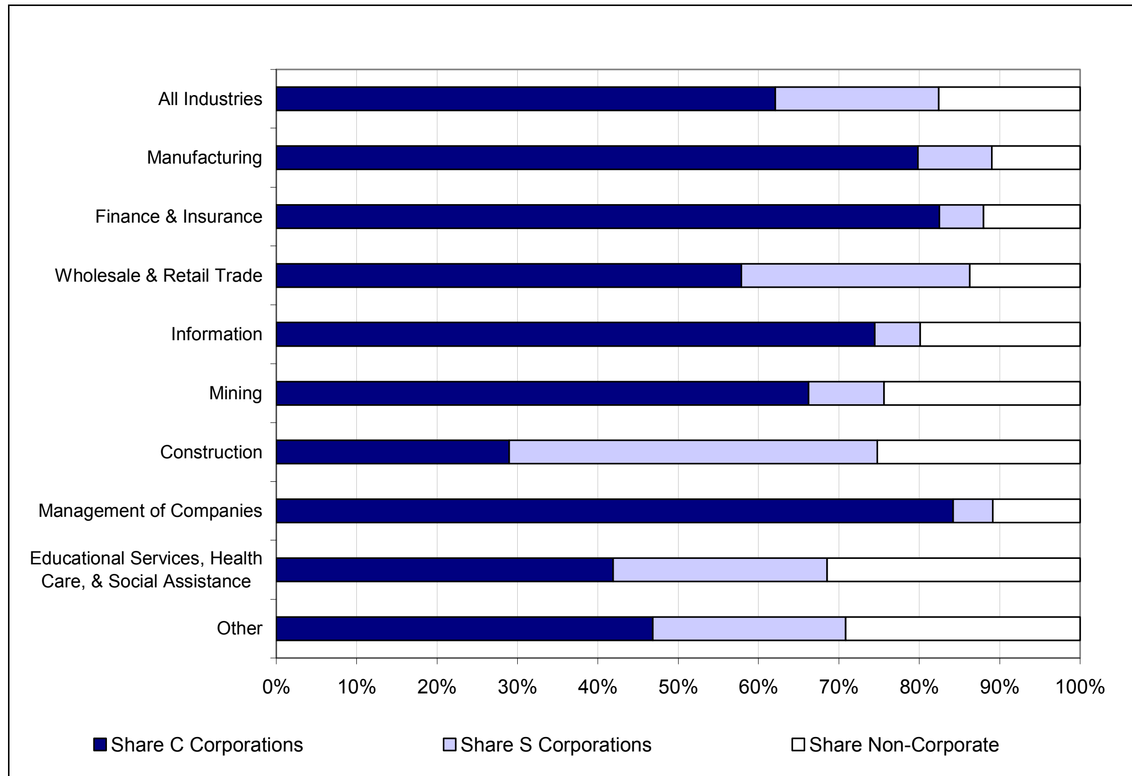
There are some notable limitations associated with using 2008 data to evaluate Section 199 claims being made by the oil and gas sector. First, for much of 2008, oil prices were unusually high. In recent years, as oil prices have trended upwards, so have revenues and reported net income among the major integrated oil companies.[52] Second, 2008 data does not reflect the limitation of the Section 199 deduction for the oil and gas sector. For years after 2010, the share of the benefits associated with the Section 199 deduction attributable to the oil and gas sector would be expected to fall, as the sector's deduction is limited to 2/3 of what is available to other qualifying sectors.

The analysis of the distribution of Section 199 claims across industries has, so far, focused on the corporate sector. But, some of the benefits of the Section 199 deduction flow through S corporations or partnerships and are claimed on individuals' income tax returns. In 2008, the most recent year for which IRS Corporate SOI data are available, an estimated 75% of the revenue loss associated with the production activities deduction was attributable to the corporate sector (**Table 1** above).

There is diversity across industries in the amount of economic activity that takes place in the corporate sector. Across all industries, 62% of business receipts are received by C corporations (see **Figure 3**) and 53% of profits are earned by C corporations (see **Figure 4**). Relative to other industries, economic activity in the manufacturing sector tends to be concentrated amongst C corporations. Nearly 80% of manufacturing business receipts and 77% of manufacturing business profits are earned by C corporations. The finance and insurance as well as the information sectors also tend to have business activity concentrated in C corporations.

[52] For additional information, see CRS Report RL34689, *Oil Industry Financial Performance and the Windfall Profits Tax*, by (name redacted) and (name redacted).

Figure 3. Share of Business Receipts by Sector: Corporate Verses Non-Corporate
2007



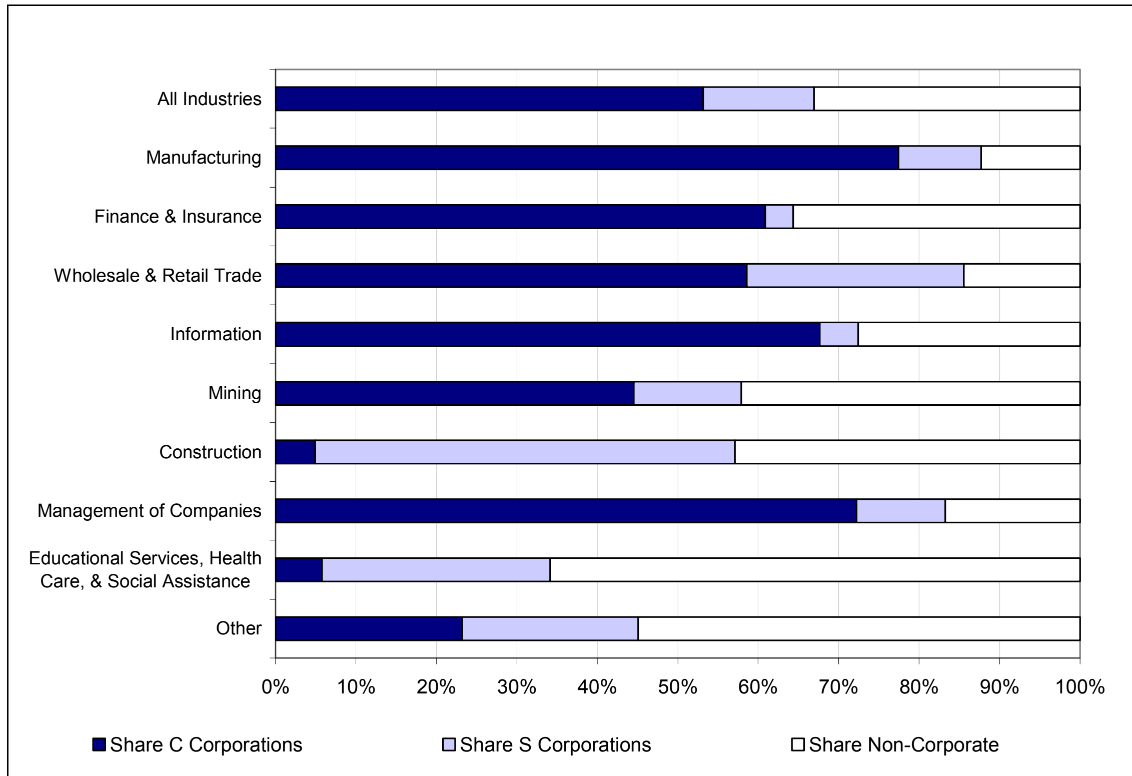
Source: CRS calculations using data from the Internal Revenue Service, Statistics of Income, Integrated Business Data.

Notes: Other industries include agriculture (including forestry, fishing, and hunting), utilities, transportation & warehousing, real estate & rental leasing, professional services, administrative support, waste management, arts & entertainment, accommodation, food services, and other services. The non-corporate sector includes partnerships as well as nonfarm sole proprietorships.

Not all industrial sectors that tend to benefit from the Section 199 deduction tend to have economic activity concentrated in C corporations. Benefits from the Section 199 deduction to sectors that tend to have a higher proportion of business activity in S corporations or the non-corporate sector are not reflected in the SOI data in **Figure 1**. In the construction sector, for example, 29% (see **Figure 3**) of business receipts and 5% (see **Figure 4**) of profits, are earned by C corporations. Most of the taxable income and tax benefits for this sector flow through to individuals. This share can have potentially important implications for tax reform. For example, if the Section 199 deduction is repealed in exchange for a revenue-neutral lower corporate tax rate, the construction sector stands to lose. All businesses in the construction sector that were previously eligible for the Section 199 deduction would see their effective corporate tax rates rise. Further, if the revenues generated from repealing the Section 199 deduction are used only to reduce tax rates for C corporations, most construction activity would not benefit.

Figure 4. Share of Profits: Corporate Versus Non-Corporate

2007



Source: CRS calculations using data from the Internal Revenue Service, Statistics of Income, Integrated Business Data.

Notes: Profits are defined as net income (less deficit). Other industries include agriculture (including forestry, fishing, and hunting), utilities, transportation & warehousing, real estate & rental leasing, professional services, administrative support, waste management, arts & entertainment, accommodation, food services, and other services. The non-corporate sector includes partnerships as well as nonfarm sole proprietorships.

Modifying the Section 199 Deduction: The Administration's Proposals

The Administration's FY2013 Budget proposes to target the Section 199 deduction towards certain domestic manufacturing activities, and increase the deduction for certain advanced technology manufacturing activities. The Administration has expressed concern with respect to the range of activities that qualifying for the Section 199 deduction, noting that the "current domestic production deduction applies to a broad range of activities beyond the core manufacturing activities."[53]

[53] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, Washington, DC, February 2012, p. 30, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

Under the Administration's FY2013 budget proposal, income derived from the production of oil and gas, coal, other hard mineral fossil fuels, and other unspecified nonmanufacturing activities would no longer qualify for the Section 199 deduction. Repeal of the Section 199 deduction for oil, gas, coal, and other hard mineral fossil fuels has been estimated to generate $18.2 billion over the 2011 through 2021 budget window.[54] The Administration proposes to use the revenues generated to increase the deduction for certain advanced technology property manufacturing. The Administration estimates that the deduction for targeted property could be increased to 18%, while remaining revenue neutral over the 10-year budget window.

The Administration has also proposed modifying the Section 199 deduction as part of a broader corporate tax reform effort. Included in the February 2012 framework for business tax reform is a proposal that would increase the production activities deduction to 10.7% for manufacturing activities. The framework indicates that a larger deduction would be provided for certain "advanced manufacturing" activities. Additional details, however, were not provided.

Increasing the Section 199 production activities deduction would reduce the effective tax rate on eligible activities. Under current law, the 9% deduction reduces the effective tax rate by 3.15 percentage points, making the top effective tax rate for qualifying activities 31.85%.[55] Increasing the deduction to 18% would reduce the effective tax rate by 6.3 percentage points. Thus, under the President's FY2013 budget proposal, advanced technology manufacturing would face a maximum effective tax rate of 28.7%. Various other tax provisions likely further reduce the effective tax rate faced by advanced technology manufacturing. The President's February 2012 framework for business tax reform proposes a corporate tax rate of 28%. The 10.7% production activities deduction proposed in this framework would reduce the effective tax rate on manufacturing activities by 3 percentage points, to 25%.

As discussed above, tax incentives that distort investment incentives can drive capital away from what would otherwise be its most productive use. Proposals to increase the Section 199 deduction for certain manufacturing activities would encourage investment in targeted sectors. Such incentives, however, could reduce economic efficiency and overall economic activity by directing capital away from its most productive use.[56]

Both of the Administration's proposals to modify the Section 199 deduction would create two classes of qualifying activities: manufacturing and advanced manufacturing. Requiring taxpayers to identify manufacturing activity income from multiple sources adds complexity to the tax code. The Section 199 production has been criticized for being complex, resulting in high compliance costs.[57] The Administration's proposals would add additional complexity to this provision.

The modification to the Section 199 deduction as proposed in the President's FY2013 Budget is one amongst a number of provisions intended to provide "incentives for expanding manufacturing

[54] See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal,* 112th Cong., JCS-3-11, June 2011, http://www.jct.gov/publications.html?func=startdown&id=3796.

[55] The 6% deduction for oil and gas reduces the effective tax rate by 2.1 percentage points, to 32.9%. Actual effective tax rates for qualifying activities may be even lower after accounting for various other tax provisions.

[56] Economic theory suggests that efficiency losses associated with tax-induced distortions rises exponentially. Thus, an increased production activity deduction could result in proportionally larger economic distortions.

[57] In testimony before the House Committee on Ways and Means on February 8, 2012, Michelle Hanlon cited the Section 199 deduction as "a complex tax rule that is expensive to comply with and expensive to police and enforce." The full testimony is available at http://waysandmeans.house.gov/UploadedFiles/HanlonTestimony78FC.pdf.

and insourcing jobs in America." While the provision might lead to additional investment in advanced technologies manufacturing, it is not clear that the modifications to this provision, as proposed in the President's FY2013 budget, would lead to additional job creation.

Reduced investment in the oil and gas sector could lead to reduced employment in that sector. However, economists have found that repeal of oil and gas related tax incentives would have a limited market impact.[58] Further, since the oil and gas industry is capital intensive, the changes in employment resulting from changes to the Section 199 deduction are likely to be small.[59] Similarly, investment in advanced technology manufacturing that is capital intensive will not have large employment effects. Modifying the Section 199 deduction to target advanced technologies manufacturing may lead to some shifts in employment across economic sectors. These shifts could have regional economic impacts, as more investment is directed towards regions engaged in advanced technology manufacturing activities, and away from regions heavily engaged in oil and gas related activities. Overall, however, this provision has limited job creation potential.

Policy Options and Concluding Remarks

Repeal of the Section 199 deduction has been considered as part of some comprehensive tax reform packages.[60] Broadening the tax base by repealing the Section 199 deduction, and using the revenue generated to reduce corporate tax rates, would remove an existing distortion in the corporate tax system and could enhance economic efficiency. It has been estimated that repealing the Section 199 deduction could generate enough in additional revenues to finance a 1.2 percentage point reduction in the corporate tax rate.[61] While repealing the Section 199 deduction could be used to achieve a lower across-the-board corporate tax rate, some sectors would likely face increased effective rates. The deduction of 9% currently reduces effective tax rates for qualified activities by 3.15 percentage points. Thus, repeal of the Section 199 deduction could increase effective tax rates for activities that currently benefit from this provision by nearly 2 percentage points.

Another group of taxpayers that could face higher effective tax rates following a repeal of the Section 199 deduction in exchange for reduced corporate rates are non-corporate taxpayers. Currently, an estimated 25% of Section 199's revenue loss is for claims made through the individual income tax system by pass-through entities, including S corporations and partnerships.

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[58] See Maura Allaire and Stephen Brown, *Eliminating Subsidies for Fossil Fuel Production: Implications for U.S. Oil and Natural Gas Markets*, Resources for the Future, Issue Brief 09-10, Washington, DC, December 2009. An analysis of two individual oil and gas companies found that repeal of the Section 199 deduction would increase their operation cash flows by 0.6% and 0.5%, respectively. See Tony Costello, *Eliminating Oil and Gas Company Tax Breaks: Independent Producers Face a Funding Gap*, Bloomberg Government, June 10, 2010.

[59] See U.S. Congress, Senate Committee on Finance, *Oil and Gas Tax Provisions: A Consideration of the President's FY 2010 Budget Proposal*, Statement of Alan B. Krueger, Assistance Secretary for Economic Policy and Chief Economist, U.S. Department of Treasury, 111th Cong., 2nd sess., September 10, 2009, http://finance.senate.gov/imo/media/doc/091009aktest.pdf.

[60] As previously discussed, the Obama Administration's business tax reform proposes to expand the production activity deduction. The President's Fiscal Commission and the Debt Reduction Task Force proposed repeal of corporate tax expenditures, including the Section 199 deduction.

[61] See CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by (name re dacted).

A repeal of the Section 199 deduction for all taxpayers would increase effective tax rates for non-corporate taxpayers, who would not receive any offsetting benefits from the corporate rate reduction. This could particularly affect sectors that benefit from the Section 199 deduction, but tend not to operate as corporations. The construction sector is one example.

Another policy option related to the Section 199 deduction would be to modify the deduction to address economic efficiency concerns. One way this could be achieved would be to allow the deduction for activities that tend to be associated with positive externalities, or tend to generate external benefits that are not reflected in market prices, and are therefore underprovided by the market. For example, research and development (R&D) activities are often believed to generate positive externalities, and thus would be underprovided in the market. It is not clear, however, that an added deduction for R&D would be preferable to the current tax incentives for R&D, or address many of the policy concerns with the currently available incentives for R&D.[62,63] Furthermore, it remains possible that the deduction could continue to distort economic activity if it remains available for activities that do not generate positive external effects.

The Section 199 deduction could also be modified to address concerns over cross-border capital flows. If one purpose of the deduction is to reduce U.S. corporate tax rates for the purpose of attracting capital, limiting the deduction to industries where cross-border capital flows are more likely to occur could help achieve this objective. For example, if capital in the corporate manufacturing sector is more likely to flow abroad than capital in the non-corporate sector, or capital in the mining and construction sectors, limiting the deduction to those in the corporate manufacturing sector could serve to attract mobile capital into the United States. Limiting the deduction would reduce revenue losses associated with the deduction, allowing additional revenues to be used for deficit reduction or another purpose.

Repealing the Section 199 deduction for certain sectors, such as the oil and gas sector, may help eliminate tax-induced distortions that might lead to overinvestment in those sectors while generating additional revenues that could be used for deficit reduction. Repealing the deduction for certain sectors, or for certain types of firms, does not, however, address the remaining distortions. Even if the Section 199 deduction were repealed for the oil and gas sector, the deduction would continue to create economic distortions by continuing to promote investment in other targeted activities.

Finally, part of the intent of the Section 199 deduction was to support the domestic manufacturing sector. While economists sometimes question whether there is an economic rationale for supporting the domestic manufacturing sector, there may be other policy motivations for writing tax policies that favor domestic manufacturing. Should Congress decide to reevaluate the current tax treatment of the U.S. manufacturing sector, the impact of the myriad of incentives benefitting the sector, including depreciation schedules and expensing allowances, investment tax policies, incentives for R&D, and the potential interactions of such policies, should be considered. One method that could be used in the future to evaluate the impacts of multiple provisions on incentives for investment in certain sectors is to use an effective tax rate approach.

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[62] For a discussion of the current research and experimentation credit, including policy concerns, see CRS Report RL31181, *Research Tax Credit: Current Law, Legislation in the 112th Congress, and Policy Issues*, by (name redacted).

[63] The 21st Century Investment Act of 2011 (H.R. 689) proposes to increase the Section 199 deduction for activities in which the associated research and development occurred within the United States.

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