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Key Issues in Tax Reform: The Section 199 Deduction

The Section 199 domestic production activities deduction reduces the effective tax rate on certain types of activities, primarily domestic manufacturing activities. Whether the Section 199 deduction should be a part of a reformed tax code is a question Congress may choose to address as it evaluates tax reform options.

For additional background, see CRS Report R41988, *The Section 199 Production Activities Deduction: Background and Analysis*, by Molly F. Sherlock.

How the Deduction Works

Currently, Section 199 allows a deduction equal to 9% of the lesser of taxable income derived from qualified production activities, or taxable income. Qualified production activities are defined to include manufacturing, mining, electricity and water production, film production, and domestic construction, among other activities. For oil- and gas-related activities, the deduction is limited to 6%. Qualifying oil and gas activities include the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof. Across all sectors, the deduction cannot exceed 50% of W-2 wages paid by the taxpayer for qualifying activities. In 2012, more than one-third of corporate taxable income was eligible for the Section 199 deduction.

The Section 199 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 rate. For income that does not qualify for the production activities deduction, p is zero.

When the production activities deduction applies, the tax rate is the statutory tax rate (generally, 35% for corporations) multiplied by $(1-p)$. 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).

Legislative History

The Section 199 deduction was enacted as a permanent provision by the American Jobs Creation Act (AJCA; P.L. 108-357) 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 several other industries by reducing effective corporate tax rates.

The Section 199 production activities deduction, as enacted in 2004, did not reach the full deduction rate of 9% until 2010. During 2005 and 2006, eligible taxpayers could claim a tax deduction equal to 3%. For tax years 2007, 2008, and 2009, the deduction rate was 6%.

Since being enacted, the Section 199 deduction has undergone a number of minor modifications. The Tax Relief and Healthcare Act of 2006 (P.L. 109-432) added the benefit for Puerto Rico, on a temporary basis. The temporary provisions allowing the deduction for qualifying activities in Puerto Rico has been extended multiple times as part of "tax extenders."

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 permanently limited to a 6% deduction for tax years starting after 2009. In addition, as part of EESA, the deduction was also modified to better accommodate domestic film production industry operations.

The Section 199 deduction was enhanced for crude oil refiners that are not a major integrated oil company as part of the Consolidated Appropriations Act, 2016 (P.L. 113-114). Specifically, the provision limited the amount of transportation costs to be taken into account when determining taxable income for the purposes of the Section 199 deduction to 25%. The result is higher net income for the purposes of calculating the deduction, and thus a larger deduction. This provision was enacted on a temporary basis to provide support for independent refiners following changes in crude oil export policy, and is set to expire at the end of 2021.

Economic Considerations

The Section 199 production activities deduction increases the after-tax return to particular investments by lowering the effective tax rate for income earned in certain industries. As a result, the deduction may distort the allocation of capital. This effect could reduce economic efficiency and total economic output by directing capital away from its most productive use. A 2017 Treasury report, "The Case for Responsible Business Tax Reform," noted that "[t]he domestic production activities deduction is difficult to justify without clear evidence that it provides offsetting social benefits of some kind. Without such a social benefit, then to the extent that it is targeted to particular industries or activities it could inefficiently encourage such activities over others that do not benefit." When evaluating the deduction in light of economic efficiency concerns, it may be helpful to consider (1) whether targeted tax benefits for manufacturing provide desired social benefits, and (2) whether the Section 199 deduction is an effective tool for providing the desired benefits.

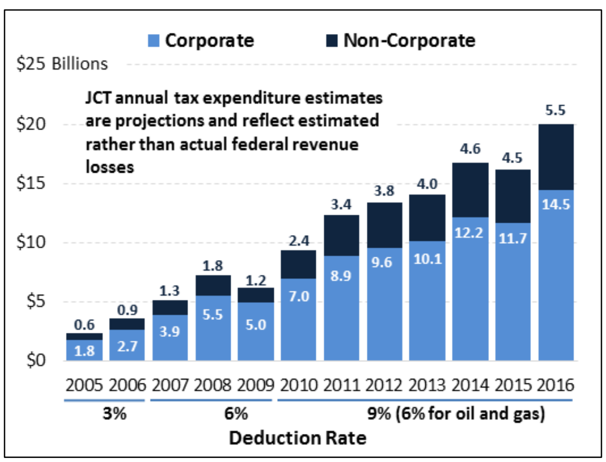
The Section 199 deduction and the associated regulations are complex, and impose an administrative burden on both taxpayers and the government. Taxpayers wanting to claim the deduction must allocate costs and jobs devoted to activities performed in the United States to determine both receipts associated with the qualified activities and associated costs. The largely fixed-cost nature of these burdens may favor larger firms over smaller firms, potentially distorting firm size choices. 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. From the perspective of the government, to the extent that Section 199 deduction claims are a point of contention, this incentive may stress the enforcement resources for the Internal Revenue Service (IRS).

The Deduction's Cost

During 2016, the production activities deduction was expected to result in $20.0 billion in foregone federal revenues ($14.5 billion for corporations, $5.5 billion for pass-through businesses with income reported on individual returns). The foregone revenues associated with the deduction have generally increased over time, in part because of the increased deduction rate (see **Figure 1**).

Figure 1. Section 199 Tax Expenditures

2005-2016



Source: Joint Committee on Taxation.

Repealing the Deduction to Offset the Cost of Rate Reduction

Repealing the deduction would generate additional revenues. These revenues could be used to offset the cost of a tax rate reduction. Eliminating the deduction for all businesses would generate enough additional revenue to offset the cost of approximately a 1.4 percentage point reduction in the corporate tax rate. If the deduction were eliminated for corporations only, it could offset the cost associated with approximately a 1.0 percentage point corporate rate reduction.

Policy Considerations and Options

Repeal of the Section 199 deduction has been considered as part of some comprehensive tax reform packages. Recent proposals would repeal the Section 199 deduction as part of a reform that repeals or restricts various tax expenditures in exchange for reduced rates. The Unified Framework for Fixing Our Broken Tax Code, issued by the Office of the Speaker on September 27, 2017, takes this approach, as did the House Republican 2016 "Better Way" Tax Reform Blueprint. The Blueprint noted that "section 199 is highly complex, often frustrating both those businesses that fail to qualify as well as businesses that do qualify but only after navigating a substantial paperwork burden." The Tax Reform Act of 2014 (H.R. 1), introduced in the 113th Congress, also proposed repealing the Section 199 deduction as part of a rate-reducing tax reform.

Repealing the Section 199 deduction is not without tradeoffs. In isolation, repealing the Section 199 deduction and providing a revenue-neutral reduction in tax rates could increase the effective tax rates of taxpayers previously qualifying for the deduction. In addition, if the deduction is repealed for all businesses, but the revenues are used only to reduce corporate tax rates, the effective tax rate on pass-through entities could increase. The issues raised by these trade-offs, however, may be addressed with other changes included in a broader tax reform proposal.

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. The Obama Administration's 2016 "Framework for Business Tax Reform," citing research on the importance of the manufacturing sector in the economy, included a proposal to increase the Section 199 deduction, but to focus the deduction more on manufacturing activity.

Repealing the Section 199 deduction for certain sectors, such as the fossil fuel sector, may help eliminate tax-induced distortions that might lead to overinvestment in those sectors while generating additional revenues. For example, the Obama Administration's FY2017 budget proposed to repeal the Section 199 deduction for fossil fuels-related activities. This proposal was part of a broader objective to "phase out subsidies for fossil fuels" that encouraged "more investment in the fossil fuels sector than would occur under a neutral system."

Finally, a key 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.

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