

## Section 199 of the Internal Revenue Code and the Internal Revenue Service's Interpretation Thereof

**Background** - A little over six years ago Congress passed the American Jobs Creation Act of 2004 ("Jobs Creation Act"). Title I of the Jobs Creation Act had two purposes: first, it repealed the Exclusion for Extraterritorial Income ("ETI") as required by a decision of the World Trade Organization and second, it added § 199 to the Internal Revenue Code of 1986. Section 199 was intended, in part, to compensate U.S. exporters for the tax benefits they would lose as a result of the repeal of the exclusion for ETI and also to encourage certain businesses to create jobs. Unfortunately, the IRS has interpreted § 199 in a manner that effectively vitiates the ability of scrap recyclers to claim the deduction, despite the fact that the scrap recycling industry is, and has been for decades, one of the United States largest net exporters, subjecting a large number of recyclers to huge deficiency assessments upon audit.

**Misguided Regulatory Interpretation** - The Jobs Creation Act grants the § 199 deduction to those who lease, license, rent or sell "qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States."<sup>1</sup> The term "qualified production property" (QPP) is defined as tangible personal property, computer software and any property described in section 168(f)(4).<sup>2</sup> Congress did not define the terms manufacture, produce, grow or extract. However, the Internal Revenue Service (IRS), when writing the regulations for § 199 elected to define those terms as follows:

*(e) Definition of manufactured, produced, grown, or extracted—(1) In general. Except as provided in paragraphs (e)(2) and (3) of this section, the term MPGE includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals...<sup>3</sup> (emphasis added)*

The exceptions contained in paragraphs (e)(2) and (3) of § 1.199-3 relate to packaging, repackaging, labeling, or minor assembly and installation, respectively. The regulation explicitly provides that QPP made out of scrap or salvage qualifies for the deduction and nowhere does it specifically exclude scrap recycling from the definition of manufacturing or producing. Unfortunately, the IRS, in its ultimate wisdom apparently issued instructions from headquarters to

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<sup>1</sup> 26 U.S.C. 199(c)(4)(A)(i)(I)

<sup>2</sup> 26 U.S.C. 199(c)(5)

<sup>3</sup> 26 C.F.R. 1.199-3(e)



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the field auditing staff directing the field staff to deny, out of hand, any §199 deduction taken by a scrap recycler. The result has been that scores of our members are facing tens of millions of dollars in back taxes for having, in good faith, taken the § 199 deduction. IRS' denial of these deductions is inconsistent with Congressional intent, IRS' own regulations, and common sense. The scrap recycling industry is one of the nation's leading exporters. A significant number of our members had benefitted from the exclusion of ETI without any challenge. Congress created §199 not only to compensate for the loss of the ETI exclusion by industries that claimed it, but to also benefit a much larger group of manufacturers. Yet, under IRS' arbitrary reading, the recycling industry that had benefitted from the ETI exclusion, and therefore was clearly intended to benefit from § 199, is being excluded by the IRS from the benefit of the § 199 deduction! Further, at the common sense level, *Webster's New Collegiate Dictionary* defines manufacture as, among other things, "to make into a product suitable for use" or "to make from raw materials by hand or by machinery." *Webster's* goes on to define "produce as, among other things, "to give being, form or shape to." It is plainly evident that a scrap recycling facility is engaged in manufacturing. Indeed, to our knowledge, every state that offers an exemption from sales tax for manufacturers' purchases of machinery and equipment used in the manufacturing process has afforded that exemption to scrap recyclers. In seven states where the issue was litigated, the state supreme courts ruled in favor of the industry. Another eight states have granted the exemption through Administrative decisions. At least two states, Utah and Arkansas, actually passed legislation specifically addressing the issue—the Arkansas legislature having taken action as a result of a judicial decision to the contrary! While the federal government is not bound by state precedent, ISRI would contend that if reason prevailed the IRS would at the very least give credence to the fact that this issue has been vetted a significant number of times. ISRI has been negotiating with the IRS on behalf of our industry for over one year now and have made little substantive progress. If the IRS does not act in a sensible manner, we are sincerely concerned about a significant loss of U.S. jobs and exports.

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