

Limited Benefit From Potential New Domestic Manufacturing Incentives

by Jessica Theilken, Monisha Santamaria,
Natalie Tucker, and Carol Conjura

Reprinted from *Tax Notes Federal*, May 19, 2025, p. 1171

Limited Benefit From Potential New Domestic Manufacturing Incentives

by Jessica Theilken, Monisha Santamaria, Natalie Tucker, and Carol Conjura



Jessica Theilken



Monisha Santamaria



Natalie Tucker



Carol Conjura

Jessica Theilken is a managing director in the Washington National Tax (WNT) methods group of KPMG LLP, Monisha Santamaria is a principal in the WNT passthroughs group, and Natalie Tucker and Carol Conjura are partners in the WNT methods group.

In this article, the authors examine the domestic manufacturing incentives included in the proposed budget reconciliation legislation and explain what's missing.

This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP.

Copyright 2025 KPMG LLP.
All rights reserved.

On May 9, the House Ways and Means Committee released the initial chair's mark containing partial text of the tax provisions for the budget reconciliation legislation now pending in the House. It was followed on May 12 by an amended chair's mark containing a more fulsome list of tax provisions for the budget reconciliation legislation.¹ The amended mark includes numerous proposed tax cuts (among other tax

proposals),² including a proposal allowing full expensing of "qualified production property" and a proposed increase in the gross receipts threshold under section 448(c) for small manufacturing businesses. Some taxpayers likely welcome these incentives; however, many domestic manufacturers would be excluded from these

¹ See "The One, Big, Beautiful Bill," released May 12, 2025.

² Notable proposals that are included in the amended mark but are outside the scope of this article include the reduction of tax rates and lowering of the tax brackets applicable to individual taxpayers, expensing of domestic section 174 costs, revising the computation of the section 163(j) limitation on interest deductibility to permit the limitation to be based on earnings before interest, taxes, depreciation, and amortization, extension of 100 percent bonus depreciation, and extension and expansion of section 199A, among many others.

benefits and likely are wondering what happened to the promised rate reduction for U.S. manufacturers.³ As Congress continues to review and modify the proposed legislation, considerations should be given to the limitations on the incentives as currently proposed and should consider reviving in some form the more inclusive prior domestic manufacturing incentives to implement the promised rate reduction for U.S. manufacturers. In doing so, the history of prior domestic manufacturing incentives and other existing guidance and need to modernize the definition of manufacturing could help guide the process.

I. What Manufacturing Incentives Were Included in the One, Big, Beautiful Bill?

A. Special Depreciation Allowance

The bill would create a special depreciation allowance for qualified production property, permitting a deduction of 100 percent of the adjusted basis of certain nonresidential real property used in qualified production activities for which construction begins after January 19, 2025, and before January 1, 2029, and that is placed in service in the United States (or any possession of the United States) before January 1, 2033.⁴ Eligible property is property used by the taxpayer as an integral part of a qualified production activity and includes new property as well as used property that was not previously used by any person in a qualified production activity during the period beginning on January 1, 2021, and ending on May 12, 2025.

Qualified production activities under the proposal include manufacturing, production, or refining activities that result in the substantial transformation of a qualified product. The proposal limits the term “production” to

agricultural production and chemical production activities and the term “qualified product” to tangible personal property. It is unclear how many taxpayers will benefit from this proposal since bonus-eligible property under section 168(k) already includes qualified improvement property,⁵ certain real property used in designated manufacturing activities,⁶ and certain agricultural buildings and structures.⁷ The requirement that construction not commence until after January 19, 2025, and that acquired facilities cannot have been used in qualified production activities for the previous four years also limits the universe of benefited taxpayers. This proposal would also require taxpayers to recapture all depreciation if the use of the property changes during the 10-year period beginning with the placed-in-service date for the qualified production property, likewise limiting potential benefits.

B. Expansion of Small Business Exception for Manufacturing Taxpayers

Under section 111110 of the bill, the gross receipts threshold under section 448(c)⁸ would be increased to \$80 million for certain manufacturing taxpayers for tax years beginning after December 31, 2025. Manufacturing taxpayers would include corporations or partnerships that derived substantially all of their gross receipts during the previous three tax years from the lease, rental, license, sale, exchange, or other disposition of qualified products. Qualified products would include tangible personal property (other than food or beverages prepared in the same building as a retail establishment in which substantially similar property is sold to the public) produced or manufactured by the taxpayer in a manner that

⁵ See section 168(e)(3)(E)(vii) and (e)(6).

⁶ See, e.g., asset class 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674.

⁷ See section 168(e)(3)(D)(i) and (i)(13), and asset classes 01.3 and 01.4 of Rev. Proc. 87-56.

⁸ Under current law, with certain exceptions, a C corporation or partnership with a C corporation partner may use the cash method of accounting only if its average annual gross receipts (based on the prior three tax years) do not exceed \$25 million (indexed for inflation for tax years beginning after 2018). The gross receipts threshold is \$31 million for 2025 (see Rev. Proc. 2024-40, 2024-45 IRB 1100, section 2.31).

³ See Alexander Rifaat, “Trump Proposes 15 Percent Corporate Tax Rate — With a Catch,” *Tax Notes Federal*, Sept. 9, 2024, p. 2173; “Trump Tax Cuts Turn Seven,” Road to 47: The Trump-Vance Transition Newsletter (Dec. 24, 2024); and White House, “Remarks by President Trump in Joint Address to Congress” (Mar. 6, 2025).

⁴ See section 111101 of the bill, “Special Allowance for Qualified Production Property.”

results in a substantial transformation of the property (within the meaning of the proposal discussed above).⁹

The gross receipts test under section 448(c) is used in various code sections in determining whether a taxpayer is a small taxpayer eligible for an exception to the application of a provision. Thus, for example, applicable taxpayers under the proposal that generally have average annual gross receipts exceeding \$25 million but less than \$80 million would be entitled to use the cash receipts and disbursements method of accounting and would be eligible for the exception from the requirement to account for inventories under section 471, the small taxpayer exception for the capitalization requirements under section 263A, and the small business taxpayer exception to interest expense deduction limitations under section 163(j). Relief from the requirement to use the accrual method and from other provisions of the code that create administrative burdens will surely be well received by small manufacturing taxpayers. However, there could be inconsistencies in which taxpayers would be considered manufacturers for purposes of the proposed section 448(c) rule versus for other purposes of the code.

II. What's Missing From the Bill?

Noticeably absent from the proposal is a revival of (or introduction of a proposal similar to) the former domestic production activities deduction (DPAD) under section 199, which was repealed in 2017 by the Tax Cuts and Jobs Act.¹⁰ President Trump, on numerous occasions, indicated that a tax bill would include a tax rate cut, or an effective tax rate cut, for companies that manufacture their products in the United States. The implications of these statements were that an incentive would apply broadly to any company that engages in manufacturing activities within

the United States. It was widely speculated that this policy goal would be accomplished by reinstating a permanent reduction to taxable income similar to former section 199.¹¹

While the manufacturing incentive under former section 199 broadly applied to taxpayers producing tangible personal property, software, film, and sound recordings, as well as to taxpayers conducting certain services (such as engineering or architectural services performed in the United States regarding the construction of real property in the United States), the current proposals as drafted stand to exclude many U.S. manufacturers from receiving any incentives for keeping or increasing production in the United States. As noted above, the proposed special depreciation allowance for qualified production property would apply only to taxpayers constructing or purchasing applicable nonresidential real property on or after January 20, 2025, and would not, for example, apply to any taxpayer that increases or maintains U.S. production activities within an existing nonresidential real property footprint. Further, while full expensing of nonresidential real property that ordinarily is subject to a 39-year recovery period¹² would be welcomed by some taxpayers, the proposed incentive would merely result in a difference in the timing of deductions for depreciation — not in the previously promised reduction in the effective corporate rate from 21 percent to 15 percent for U.S. manufacturers, with permanent benefits.

III. Limited Manufacturing Activities Included

The proposals included in the One, Big, Beautiful Bill use a relatively narrow definition of the term “manufacturing.” For instance, the proposed special depreciation allowance applies only for manufacturers of tangible personal property and excludes taxpayers producing software, film, and sound recordings. The proposed special depreciation allowance also limits the term “production” to agricultural and

⁹ Solely for purposes of determining if a taxpayer is a manufacturing taxpayer under this provision, the aggregation rule under section 448(c) would be expanded to include the gross receipts of passive trades or businesses under section 469(c)(5) and (6). Thus, for example, in determining whether a manufacturing taxpayer is eligible for the \$80 million gross receipts threshold, the gross receipts of a partnership engaged in an activity that gives rise to section 212 deductions may be aggregated with those of the manufacturer under section 52(b).

¹⁰ P.L. 115-97 (Dec. 22, 2017).

¹¹ See Jessica Theilken et al., “New Year, Old Tax Law: Will Section 199 Make a Comeback?” *Tax Notes Federal*, Jan. 20, 2025, p. 515. In the form of a deduction, this would equate to allowing a deduction of close to a 30 percent to achieve a 15 percent effective rate.

¹² Section 168(c).

chemical production. Similarly, the increased gross receipts threshold for certain other incentives such as permitting the cash method and waiving section 263A applies only to certain small taxpayers engaged in the manufacturing, production, or refining of tangible personal property. However, in a revised bill, Congress could look to former domestic production incentives as well as current law to identify eligible manufacturing activities.

It is noteworthy that both the statute and regulations under former section 199 defined eligible activities very broadly. Manufacturing activities included manufacturing, producing, growing, extracting, installing, developing, improving, and creating qualified property, and film production. Manufacturing activities also included the making of qualified property 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. Further, cultivating soil, raising livestock, fishing, and mining minerals were included.¹³ In drafting the former section 199 rules, Congress expressly indicated its intention that the term “manufacturing” be broadly applied.¹⁴ As a result, taxpayers (regardless of entity type) in a wide range of industries and conducting a wide variety of activities were eligible for the incentive.

A series of taxpayer-favorable cases confirmed the broad definition of manufacturing under former section 199 to cover taxpayers performing activities that include purchasing products manufactured by third parties in order to conduct additional subassembly processes that “change the form or function” of the original

property. For example, the production of gift baskets or gift towers¹⁵ and the development of unit doses of medication qualified.¹⁶ A similarly broad definition of manufacturing in the context of proposed sections 168(n) and 448(c)(4) would be welcome by taxpayers and could be viewed as consistent with the administration’s policy goals.

Congress could also consider the broad definition of production under section 263A when defining activities eligible for the new incentives. Section 263A requires the capitalization of certain costs and is applicable to inventories produced (or purchased for resale), as well as self-constructed assets produced for a taxpayer’s own use. Section 263A and the regulations thereunder broadly define the term “produce” as construct, build, install, manufacture, develop, improve, create, raise, or grow.¹⁷ Property subject to section 263A includes tangible property, certain agricultural or horticultural commodities,¹⁸ and certain intellectual or creative property, such as films, sound recordings, videotapes, books, and similar property.¹⁹ At a minimum, taxpayers that are considered producers and are therefore subject to the capitalization rules under section 263A should seemingly be treated as manufacturers or producers for purposes of proposed sections 168(n) and 448(c)(4).²⁰

¹⁵ See *United States v. Dean*, 945 F. Supp. 2d 1110 (C.D. Cal. 2013), in which the taxpayer purchased various food items that were assembled in gift baskets or gift towers based on detailed production plans and using assembly line workers and machines. The court found that the taxpayer changed the form and function of the individual purchased items by creating distinct gifts that were a new product with a different demand than the individual items themselves, comparing the production process to assembling a car after purchasing various automobile parts from suppliers.

¹⁶ See *Precision Dose v. United States*, 116 AFTR 2d 2015-6231 (N.D. Ill. 2015). The court in *Precision Dose* determined that a taxpayer that sold unit doses of medication in nonreusable containers intended for administration as a single dose to patients was conducting manufacturing activities. Citing *Dean*, 945 F. Supp. 2d 1110, the court reasoned that a unit dose of medication did not exist without the taxpayer engaging in a “complex production process that results in a distinct final product.”

¹⁷ Section 263A(g)(1) and reg. section 1.263A-2(a)(1)(i).

¹⁸ See section 263A(d) and (e), and reg. section 1.263A-4.

¹⁹ Reg. section 1.263A-2(a)(2)(ii).

²⁰ This was the case under former section 199. See former reg. section 1.199-3(e)(4) (“consistency with section 263A”).

¹³ Former reg. section 1.199-3(e)(1). Former section 199(c)(5) previously defined qualified production property as tangible personal property, any computer software, and any property described in section 168(f)(4) (sound recordings).

¹⁴ See, e.g., H.R. Rep. No. 108-755, at 272 (2004) (Conf. Rep.), which notes that a taxpayer that buys coffee beans that it roasts in a processing facility and then uses in the preparation of brewed coffee at a retail establishment would be eligible to treat the portion of its gross receipts from the sale of brewed coffee that relates to the roasting of the coffee beans as eligible for the deduction.

Congress should also consider allowing these incentives (or any other manufacturing incentives included in a revised bill) to broadly apply to software developers.²¹ In recent years, the technology industry has significantly expanded and evolved. With the rapid expansion of AI technology, investments in property that houses AI data centers are rapidly increasing.²² Given the current administration's stated intention to lead the world in AI innovation²³ and the general increased investment in AI solutions across many industries, Congress should consider expressly including the development of AI, as well as other software, in the definition of manufacturing activities eligible for any proposed manufacturing incentives.

²¹ See Theilken, Monisha Santamaria, and Natalie Tucker, "Any Domestic Manufacturing Incentive Will Need Updated Definitions," *Tax Notes Federal*, May 5, 2025, p. 845.

²² Investments in the data center industry are projected to reach \$1 trillion by 2027. See PwC US, "Data Centers at the Crossroads of Technology and Resilience" (Feb. 2025). Also, the global data center construction market is expected to reach \$416.4 billion by 2032. See Allied Market Research, "Data Center Construction Market" (June 2024). See also Andrew Foote and Caelan Wilkie-Rogers, "Data Centers Growing Fast and Reshaping Local Economies," U.S. Census Bureau Center for Economic Studies (Jan. 6, 2025), noting that "employment in U.S. data centers — facilities that house the computer systems that store and manage data — increased more than 60 percent nationally from 2016 to 2023."

²³ See, e.g., "2024 GOP Platform: Make America Great Again!" Road to 47: The Trump-Vance Transition Newsletter, July 8, 2024.

IV. More Work to Be Done

Although a significant step, the release of the Ways and Means Committee's initial chair's mark and amended chair's mark are just first steps in the process of enacting a budget reconciliation bill. There are likely to be significant changes to the bill throughout this process, meaning there is much uncertainty about how the proposed domestic manufacturing incentives will be incorporated into a final bill. While the inclusion of proposals to incorporate full expensing of manufacturing facilities and an increased gross receipts test threshold for certain small manufacturers in the proposed reconciliation bill are welcome developments for certain taxpayers, additional work is needed if policymakers intend to fulfill Trump's promised tax agenda as related to domestic manufacturing.²⁴ ■

²⁴ The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP. KPMG LLP is a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Ltd., a private English company limited by guarantee.