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Domestic Production Activity Deduction - Don't miss out!

What is it?

The Domestic Production Activity Deduction ("DPAD") was first passed in 2004, then amended retroactively in 2005, and then amended again in 2006. The DPAD encourages domestic production activities through a tax deduction benefiting businesses and individual taxpayers who engage in those production activities.

Commencing with 2005, businesses engaging in domestic production activities may deduct an applicable percentage of their qualified production activities income (as defined below, "QPAI"). As with most tax benefits, the DPAD is subject to various qualifications and limitations, which may limit/preclude the deduction's size or availability. The most critical limitation ties the DPAD's benefit to paid wages which ensures that most of the DPAD's benefit goes to businesses either creating and/or maintaining jobs.

When did the DPAD start?

The DPAD is effective for corporations, partnerships, S corporations and individuals for taxable years beginning after December 31, 2004. Collectively, corporations, partnership and S corporation owners and individuals are referred to as "qualifying businesses", subject to the law's definitions briefly discussed below.

How does the DPAD work?

Qualifying businesses deduct a percentage of their QPAI from taxable income (for corporations) or adjusted gross income (for individuals).

Tax Year:	Applicable Percentage of QPAI:
2005-6	3%
2007-9	6%
2010—	9%

For instance in 2010, the DPAD is equivalent to a 3% tax rate reduction for qualifying income, assuming a corporate tax rate of 34%. The DPAD may be effective for state tax purposes too, although some states may "decouple" from the federal deduction to avoid business tax revenue losses.

What businesses or activities qualify?

DPAD qualification largely depends on the nature of the business as its underlying theme is the encouragement of U.S. job formation. As with many legislative pieces "favored sons" exist. Their qualification is made relatively simple. These businesses are: (1) film production where at least 50% of the compensation is paid for services performed in the United States; (2) the sale (but not transmission or distribution) of electricity, natural gas, or potable water produced in the United States; (3) construction of real property in the United States; and (4) engineering and architectural services performed in connection with U.S. real property construction.

The economic activities qualifying for the DPAD should benefit most businesses. These "activities" include the lease, rental, license, sale, exchange or other disposition of "**qualifying production property**"; provided, that, it's manufactured, produced, grown, or extracted by the taxpayer "**in whole or significant part in the United States**".

As one can imagine, these defined terms are fraught with complexity in the IRS regulations; if you have questions you should consult your H&M tax consultant for clarification.

What products qualify?

DPAD qualifying production property includes: (1) "**tangible personal property**", (2) computer software, and (3) sound recordings; but does not include: (a) prepared food and beverages sold at a retail establishment, (b) leased, rented, licensed, sold or exchanged land, and (c) any property leased, licensed or rented to a related party. So, in most general terms this seems to encompass traditional manufacturing activities, the production of agricultural products, and the traditional extractive industries.

"Tangible personal property" means any tangible property (including any gas, other than natural gas, chemicals, steam, oxygen, hydrogen, and nitrogen), other than land and certain real property, computer software, sound recordings, qualified films, and utilities.

Property is produced "in whole or significant part in the United States" if the incurred US direct labor and overhead costs are at least 20% of the property's total cost of goods sold. In transactions without cost of goods sold (*i.e.*, lease, rental, or license), the US incurred direct labor and overhead must be at least 20% of the taxpayer's unadjusted depreciable basis in the property.

There's a maze of rules regarding allocations of receipts and expenses to domestic production activities within the IRS regulations. Your H&M tax consultant can guide you through them.

How is the DPAD calculated?

Once a business and its activities qualify, its "qualified domestic production receipts" are reduced by: (1) cost of goods sold; and (2) other expenses, losses, and deductions (other than the deduction for domestic production activities) that are, in each case, allocable to those receipts. The result is the taxpayer's qualified production activities income ("QPAI"), to which the taxpayer applies the applicable percentage to determine its DPAD; provided, however, the actual DPAD may not exceed 50% of the taxpayer's W-2 wages for the taxable year. However, for tax years beginning after May 17, 2006, this wage limitation is modified so only W-2 wages properly allocable to qualified domestic production receipts are considered in such limitation. Thus, businesses relying primarily on contractors, or requiring only a small employee base, may have a decidedly smaller DPAD than anticipated.

Where to start?

The DPAD and its related provisions contain numerous traps for the unwary, and place a premium on planning/organizing your production activities for both DPAD qualification and maximization. Your safest bet is to involve your H&M tax consultant at the earliest stage possible.

To learn more about the Domestic Production Activity Deduction and how it could be applied to your business, contact Stephen C. Smith or your Holbrook & Manter representative. We have facilitated tax savings for a number of growth-minded clients.

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A Dollar Today is Worth More than a Dollar Tomorrow

Cost Segregation Studies Can Free Cash Flow

Weak economies slim-down profit margins, tighten credit markets, and restrict investment capital. Under these conditions, prudent business owners look for unconventional capital sources. One such unconventional source begins with a Cost Segregation Study (a “Cost Seg”). A Cost Seg can free cash for capital expenditures or normal operations.

Manufacturers can save on upgrading their production center; retailers can fund new/improved storefronts in existing and new markets; shopping malls or office building can remodel to lower energy costs and attract new tenants. The possibilities seem limitless. Interestingly, Cost Segs can enhance a business with no expansion/updating objectives too.

Cost Segs are technical tax componentizations applied to commercial buildings constructed, remodeled, expanded or purchased since 1987. Cost Segs can result in sizeable tax savings by accelerating depreciation allowances. Even the U.S. Treasury Department advised in the *Wall Street Journal* that Cost Segs “should be considered in almost every real estate purchase.”

Whether or not you’re considering a real estate purchase – or recently made one – multiple reasons exist for considering a Cost Seg.

A Cost Seg segregates the costs of various building parts/components. This permits classifying certain parts/components as “personal property” or “land improvements” rather than “real property.” This classification reduces your tax bill by accelerating available depreciation deductions.

Real property depreciation is figured over extended lives (as long as 39 years). Long lives mean small annual depreciation deductions. Personal property depreciation routinely entails substantially shorter depreciation lives such as 5, 7 and even 15 years. Shorter lives mean larger depreciation deductions. *“A dollar in your pocket today is worth more than a dollar in your pocket in 2050.”* Consequently, reclassifying $100,000 worth of lighting, plumbing, HVAC and other such assets as five-year personal property (as opposed to real property) creates roughly $16,000 in net-present-value tax savings (assuming a 5% discount rate and a 35% marginal tax rate).

Newly constructed improvements may qualify for either bonus depreciation or expensing under IRC §179. In any event profitable manufacturers moving to new (or at least new to them) facilities may find a Cost Seg results in partially funding the costs of buying and renovating the facility. A business with a net operating loss (aka NOL) may be able to carry back the Cost Seg-generated depreciation losses and secure cash refunds of prior year taxes.

A peripheral benefit of reclassifying building components as personal property may permit real property value reductions for “property tax” purposes. And Cost Seg componentization simplifies writing off the lighting, plumbing, HVAC or other such assets when they are replaced or become obsolete.

Be Proactive!

The IRS requires thorough and detailed records for Cost Segs to achieve their desired results. Hence, a Cost Seg specialist becomes indispensable. In new construction early specialist involvement assures more suitable documentation respecting personal property's use and cost. Specialists also assist your architects or engineers with creating necessary information and documentation. This is particularly valuable in constructing complex and highly detailed buildings.

Cost Segs are both possible and valuable after construction is complete. Success in this setting depends on recognizing, documenting and valuing all building components so the reclassification is approved by the IRS. In this setting IRS approval is necessary. Here is where the specialist really proves his/her worth.

Cost Segs can be applied to most types of commercial buildings, but conventionally Cost Segs are most valuable regarding specialized buildings such as manufacturing and processing plants, hotels, banks and apartment buildings.

A Cost Seg may be just the cash flow boost your business has been seeking.

To learn more about Cost Segs and how they may favorably impact your business, contact Stephen C. Smith or your Holbrook & Manter representative before attempting any Cost Seg. We facilitate Cost Segs for growth-minded clients.

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Energy Efficient Commercial Building Deduction:

The Energy Policy Act of 2005 introduced a tax incentive directed at improving commercial building energy efficiencies. The Energy Efficient Commercial Building Deduction, codified as IRC § 179D, (the "Deduction") encourages building owners and companies to improve facilities' energy usage. Hence, "Going Green" not only saves on utility bills, but it can also save taxes!

The Deduction also provides tangential benefits in the form of rebates from utility providers such as American Electric Power and low interest financing sponsored by the Ohio Department of Development.

Regrettably, this deduction is used by only about ten percent (10%) of otherwise qualifying projects. And, it is probably even less frequently considered in the cost/benefit analyses of most renovation projects. Don't have regrets; save money and taxes!

How Does the Deduction Work?

The Deduction can reward companies and building owners who make qualifying improvements to a building's envelope (the "Envelope"), the HVAC/hot water systems (collectively, the "HVAC"), and the interior lighting systems ("Lighting"). You should bear in mind that this Deduction is a source of ordinary income for recapture purposes on the disposition of depreciable personal and real property.

The technical standards for the Deduction are beyond the scope of this piece. However, in general terms, if these building system improvements result in a fifty percent (50%) reduction in the building's energy/power costs (when compared to a "reference building") this Federal tax deduction can equal as much as the product of $1.80 per square foot (or $ 0.60 per square foot for each system {***i.e.*** the Envelope, HVAC and the Lighting}) and the building's floor area.

Analysis suggests that this makes energy improvements made in building with areas of 20,000 square feet or more quite attractive. Although, both larger and smaller building do qualify, and therefore the Deduction should be seriously considered wherever renovations touch on the Deduction's areas of interest.

Each system has its system specific energy targets (at least until regulations are promulgated).

As for Lighting, the lighting power density must be reduced forty percent (40%) (or fifty percent (50%) in the case of warehouses). Also, if the new Lighting reduces its power density by twenty-five percent (25%) the Deduction is equal to $ 0.30 per square foot with the rate prorated for power density reductions between 25% and 40%.

The Deduction is allowed for both new construction and remodeling and these improvements must be placed in service between 2006 through 2013.

Note that this Federal tax incentive is a “deduction” rather than a “tax credit”, meaning that the cash benefit is calculated by multiplying the deduction times the tax rate. We can assist you to compute your estimate your tax savings.

Examples of Energy-Efficient Building Materials and Systems:

- Envelope - High-efficiency insulation in walls, ceilings and floors
- HVAC - Automatic thermostats and other monitoring equipment
- Lighting - Energy-efficient fixtures, controls and monitoring equipment
- HVAC - Ultra-efficient air conditioners and furnaces
- Envelope - High-performance glazing and other energy-efficient materials on the building envelope
- HVAC - Natural ventilation
- Lighting - Day-lighting
- HVAC - Improved fan efficiency

Claiming the Deduction:

- The building must meet energy and power costs reduction standards as detailed in **ASHRAE** Standard 90.1-2001; Energy Standard for Buildings Except Low-Rise Residential Buildings (effective April 2, 2003).
- An independent, qualified individual must verify and certify that the property installed satisfies specific energy efficiency requirements using IRS-approved software.

How Can H&M Help?

As with most governmental incentive programs, this Deduction provides many obstacles that frustrate taxpayers’ full utilization of it. H&M can assist you through-

- We can calculate the amount of the Deduction;
- We can effectively claim the Deduction on your federal income tax return; We can secure necessary government agency assignment where/if necessary;
- We can file amended tax returns to claim the Deduction;
- We can request necessary accounting method changes to permit claiming the Deduction;
- We provide necessary energy efficiency certifications through a network of technical specialists—
    - Review construction documents;
    - Make site visits; and
    - Hold discussions with building designers, project managers and related personnel.

If the Deduction is appealing to you, please contact Stephen C. Smith, or your H&M tax advisor to explore the Deduction’s use your situation. We facilitate such Deductions for growth-minded clients.

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IC-DISCs create tax incentives for exporters

Emerging technologies and markets make worldwide trade more accessible and attractive than ever. What's often overlooked is a tax incentive for companies to think globally: the Interest Charge-Domestic International Sales Corporation ("IC-DISC"). IC-DISCs were designed to provide a valuable tax break for exporters of US sourced goods and services.

Currently, IC-DISCs can provide up to a 20 percent tax advantage on qualifying export income. And, IC-DISCs are not difficult to set up and maintain. If you export U.S.-made products, you should give an IC-DISC serious consideration.

IC-DISCs are essentially a "special purpose corporation" whose principal purpose avails exporters a statutorily mandated tax incentive by (1) not taxing the IC-DISC (2) allowing the related exporter to deduct its IC-DISC payments and (3) taxing IC-DISC owners at a 15% rate on distributions.

The tax savings/incentive can equal 20% if the exporter pays federal income taxes at the 35% and its deductible payments to the IC-DISC are distributed to its owners who are taxed at a 15%. Obviously if tax changes affect the relationship between corporate rates and individual dividend rates this incentive may reduce or disappear.

IC-DISC Requirements

An IC-DISC is not required to (a) perform services, (b) hire employees or (c) have any tangible assets. But IC-DISCs must maintain their own financial and accounting records, and must file a federal tax return.

The export company can be a C Corporation, S Corporation, LLC or partnership, and the IC-DISC shareholders can be individuals, corporations, trusts or a combination. But IC-DISCs can only be C Corporations.

At least 95 percent of the IC-DISC's income and assets must be related to export activity, and the exported product must be comprised of at least 50 percent U.S. content. There is an exception for architects and engineers who work on projects that will be constructed outside the U.S.
The other IC-DISC requirements include:

- It must be approved by the Internal Revenue Service. The paperwork must be filed within 90 days of the start of the tax year.

- It must be incorporated in one of the 50 states or the District of Columbia, which means the IC-DISC, might have to pay state income tax on the commissions it receives from the export company.
- It must have only one class of stock with a par value of at least $2,500.

Operating as an IC-DISC

Once the IC-DISC has been created and IRS approved, the export company can begin to see financial benefits, but not before.
The export company pays a commission to the IC-DISC equal to no more than the greatest of: (i) 4 percent of the gross receipts from all qualified export sales, (ii) 50 percent of net income from all qualified export sales or (iii) a commission acceptable under traditional related party pricing rules.

Other considerations

It is worth noting that the shareholders of the IC-DISC do not need to match the shareholders of the parent company. In certain estate-planning circumstances, it can be helpful to structure ownership of the IC-DISC different from the parent company.

IC-DISC shareholders are able to defer tax on commissions by paying a small interest charge at the T-bill rate, which recently has been less than 1 percent.

As with any tax incentive, there are complex regulations that you must always be aware of. But at its core, IC-DISC is a valuable boost for American companies that wish to compete on a global stage.

To learn more about IC-DISC and how it could be applied to your business, contact Stephen C. Smith or your Holbrook & Manter representative. We have facilitated tax savings for a number of growth-minded clients.

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R&D Tax Credits-an underutilized small business benefit

If research and innovation are part of your business culture, you should consider securing R&D Credits.

The President is lobbying to both expand and extend the "research and experimentation tax credit" (the "R&D Credit"). A noble effort, but the irony is many qualified small businesses aren't availing themselves of it. Manufacturers, contractors, architects, engineers, software developers and other innovators are leaving millions, perhaps more than a billion, dollars on the table annually. Similarly, use of the "research and development" deduction has been avoided due to its status as a tax preference under the alternative minimum tax, subject to elections beyond the scope of this piece.

The R&D Credit was a Reagan Administration initiative encouraging private sector innovation and keeping pace with foreign competitors. The Bush Administration expanded the R&D Credit's application to a wider range of businesses, and the Obama Administration has proposed both making it permanent as well as expanding its application. The R&D Credit, although couched as a "temporary tax feature," has been extended 14 times. It expired at 2011's end.

Even with this underutilization, $9 billion in R&D Credits were claimed in 2008 (the most recent tax year for which data is available). *Did your business participate?*

In 2008, agricultural companies claimed more than $5 million, real estate companies claimed more than $7 million, management companies claimed more than $60 million, wholesale and retail companies claimed $430 million, and transportation equipment manufacturers claimed more than $1 billion.

Unfortunately, as a Bloomberg Government study concludes, large companies claim a disproportionate share R&D Credits because many small businesses either find it too difficult to file the IRS required information or are unaware they qualify for R&D Credits.

According to Bloomberg's study, small businesses account for 40 percent of private-industry research but received only 23 percent of R&D Credits in recent years. Bloomberg's study found a few common reasons for businesses not taking full advantage of R&D Credits:

- They do not know they qualify for a R&D Credit.
- The R&D Credit formula is too complex and the required documentation is too difficult to obtain.
- They are worried about making a long-term R&D investment when the R&D Credit could expire.

Tax credits usually mean more to profitable companies, but as R&D Credits can be claimed for all open tax years (generally meaning the current year and the past open tax years) and those credits carry forward for up to 20 years, R&D Credits may be valuable even to companies currently operating at a loss.

Defining 'R & D'

Time, money and other resources devoted to improving a product or process could result in a R&D Credit for your business. If you devoted resources are directed at:

- Research which is technological in nature.
- The activity and your devoted resources are directed at a new or improved product or process.
- The activity and your devoted resources are directed at the discovery of information that is currently unknown.
- The activity and your devoted resources must evaluate alternatives.

Hence, developing a lighter or more flexible tool, designing a unique electrical system for a new building, testing new materials, applying for a patent or streamlining an internal process can deliver an R&D Credit to your business.

R&D Credits cover employee wages directly contributing to R&D, supplies and software used in R&D activity, and contracted R&D services. There are two alternative measures of the R&D Credits:

- 20 percent of R&D expenses above a "base amount" (based on a fixed base percentage and the company's average annual gross receipts of the preceding 4 taxable year), or
- 14 percent of R&D expenses above 50% of the company's average R&D expenditures over its previous three years (aka the simple measurement).

Frequently, small businesses find it challenging to segregate normal business expenses from those that result in R&D Credits. R&D specialists can assist in that segregation process and often return R&D Credits far in excess of the specialist's fees.

Proposed simplification to R& D Credits

The Obama Administration has proposed two revisions that (a) raises the simple R&D Credit measurement to 17 percent and (b) makes the R&D Credit permanent.

Regardless of the Obama Administration initiatives success, there are short-term savings and long-term implications which make current pursuit of R&D Credits for forward looking companies desirable.

To learn more about R&D Credits and how they may favorably impact your business, contact Stephen C. Smith, or your Holbrook & Manter representative before attempting to take full advantage of R&D Credits. We facilitate R&D Credits for growth-minded clients.

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Do you use propane ("LPG") to fuel non-highway used equipment/vehicles? If so, are you missing-out on a valuable income tax credit?

The idea of utilizing alternative fuels, especially in non-highway used equipment/vehicles ("Alternative-fuel Vehicles") has truly caught-on. There are many non-tax benefits attendant with utilizing LPG under these circumstances, but are you reaping all the available tax-benefits too?

The alternative fuel tax credit landscape—

We know that the tax credits associated with "qualified alternative fuel motor vehicles (as well as mixed-fuel vehicles)" expired at the end of calendar 2010. {notable - consider benefiting from "additional first year cost recovery" or "first year expensing", under IRC § 168(k) or IRC § 179, respectively}.

Moreover, with 2013 drawing to a close, "alternative fuel refueling infrastructure" tax credits are likewise becoming unavailable.

However, all such alternative fuel tax credits haven't become extinct. Enter the IRC § 4041 "excise tax" which may provide you with a previously overlooked tax benefit.

Let's examine this excise tax credit—

An excise tax is imposed on LPG at a current rate of \$ 0.183 per gasoline gallon equivalent ("GGE") sold <u>or used by a taxpayer</u>. Please note these rates are subject to change, so contact your H&M advisor so the precise applicable credit can be determined.

So long as you are not an "alternative fueler" you may claim a credit equal to \$ 0.183 per GGE first against your own "excise tax" obligation and to the extent that your credit exceeds your excise tax liability (more likely than not that will be true) the excess becomes a credit against your "***income tax liability***."

The credit is claimed on a specific IRS form. Please contact your H&M advisor so the appropriate credits are claimed first against you excise tax obligation and then against your regular income tax liability, as appropriate as well as have him / her determine whether or not you are an "alternative fueler".

Please note that if the "excise tax" on purchased LPG was deducted on your federal income tax return then you may still claim the credit; however, you must add to income the amount of the excise tax credit. Hence, the true tax benefit is likely the excess of the excise tax credit over the tax associated with including the tax credit amount in income.

Tax overpayments are frequently the result of missing available tax saving opportunities. Don't let the LPG excise tax credit claim you as a victim! To learn more about LPG Tax credits and how they may favorably impact your business, contact Stephen C. Smith or your Holbrook & Manter representative.