

Manufacturing



Tools for thought:

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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