

Domestic production activities deduction: A good tactic for some businesses



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If you are a manufacturer that will be generating a profit this year, congratulations are in order after what has been a challenging year for most.

A reminder is also in order regarding taking advantage of the Domestic Production Activities Deduction, or the Section 199 deduction on your tax return. The deduction has a complicated set of rules, but many U.S. manufacturing companies generating taxable income may qualify for the deduction, and the permanent benefits could be significant.

Section 199 of the Internal Revenue Code was signed into law on October 22, 2004, as part of the American Jobs Creation Act of 2004, to provide a permanent benefit available to taxpayers in a wide variety of industries. Final regulations were issued in May of 2006, and a few interim notices and technical corrections have been issued, providing welcome guidance to many businesses that are dealing with the tax and financial reporting implications of Section 199.

The deduction allows businesses with “qualified production activities” to take a tax deduction for a specified percentage of their U.S. taxable income. The percentage is six percent for tax years 2007 through 2009, and beginning in 2010, it will be nine percent.

Any corporation, partnership, individual, or other business entity may claim the Domestic Production Activities Deduction if they conducted eligible qualified production activities. The list below includes some examples of eligibility:

- > Manufacturing companies based in the U.S. that are:
 - > Selling, leasing, or licensing items that have been manufactured, produced, grown, or extracted in the U.S.
 - > Selling, leasing, or licensing motion pictures that have been produced in the U.S.
- > Construction of real property performed in the U.S., including building and renovation of residential and commercial properties
- > Engineering and architectural services performed in the U.S. that relate to the construction of real property in the U.S.
- > Sale, exchange, or other disposition of electricity, natural gas, or potable water produced in the U.S.
- > Software development in the U.S., including the development of video games

Domestic Production Gross Receipts are not derived from:

- > The sale of food or beverages prepared by the taxpayer at a retail establishment (e.g., a restaurant)
- > The transmission or distribution of electricity, natural gas, or potable property
- > Property that is leased, licensed, or rented by the taxpayer for use by any related person of the taxpayer
- > The sale of land

How the deduction is generally calculated

Qualified production activities income is equal to domestic production gross receipts, reduced by:

- > The costs of goods sold that are allocable to such receipts
- > Other expenses, losses, or deductions (other than the deduction allowed under this section), which are properly allocable, directly or indirectly, to such activities

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In essence, the calculation requires a taxpayer's U.S. taxable income to be split between Section 199 eligible activities and all other activities. The tax deduction comes from multiplying the Section 199 net income by the percentage discussed above (i.e., nine percent for 2010), and this amount becomes an extra tax deduction. Some taxpayers are struggling to balance compliance with summarizing the results, which can be somewhat burdensome to manage.

If you want to claim the deduction for this tax year, now is the time to speak with a tax professional who can help you with the complex analyses required to determine the appropriate calculation that will comply with IRS guidelines.

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