

## Domestic Production Activity Deduction What every manufacturing company needs to know.

Congress enacted Internal Revenue Code Section 199, the Domestic Production Deduction, to combat the off-shoring of the global production activities, and to encourage competitiveness of U.S. companies.

The Domestic Production Activity Deduction (known as DPAD) generally allows taxpayers to receive a deduction based on the income generated from qualifying production activities, through a potentially complex set of definitions and calculations. The end result is a reduced effective tax rate or, a subsidy to the company.

Sensiba San Filippo will help you understand how to maximize your benefit from this recent code addition.

### What is the Domestic Production Activity Deduction (DPAD)?

The Domestic Production Activity Deduction (DPAD) is a tax deduction available to taxpayers engaging in qualified domestic production activities in tax years beginning after December 31, 2004. If you produce goods, develop software or construct property in the United States, you may be able to take advantage of the DPAD incentive. The deduction is a percentage of the income generated from qualified domestic production activities, but unlike so many other tax deductions, the DPAD is allowed for both regular tax and alternative minimum tax (AMT) purposes.

### What are qualified domestic production activities?

Qualified domestic production activities generally include:

- manufacture, production, growth or extraction of tangible personal property (e.g. clothing, goods or food), computer software, sound recordings or qualified film production
- production of electricity, natural gas or water
- construction or substantial renovation of real property (including residential, commercial and infrastructure such as roads, power lines, water systems, etc.), or engineering and architectural services relating to such construction

The DPAD is limited to income arising from qualified production activities conducted in whole or a significant part in the United States. Under a "safe harbor" rule, such activities qualify if at least 20 percent of the total costs are from direct labor and overhead costs from U.S.-based operations.

### How is the deduction calculated?

Calculating the DPAD can be reasonably simple or enormously complex, depending on the business. A simplified method is available for small businesses engaged in a single line of business. The deduction is equal to a percentage of the lesser of the taxpayer's qualified production activities income (QPAI) or adjusted gross income (for sole proprietors, S-corporations, partnerships or limited liability corporations) or taxable income (for C-corporations) determined without regard to the DPAD.

#### THE BASIC DPAD FORMULA

$$\text{QPAI} \times \text{QPA deduction amount} = \text{tentative DPAD}$$

## What is Qualified Production Activity Income (QPAI)?

Qualified production activity income is the taxpayer's domestic production gross receipts (DPGR) reduced by qualified production activity expenses.

## What are Domestic Production Gross Receipts (DPGR)?

Domestic production gross receipts are the gross receipts from the manufacture, production, growth or extraction of qualifying production property in whole or in significant part by the taxpayer within the US.

## What are Qualified Production Activity Expenses?

Qualified production activity expenses are all expenses *directly* related to the qualified production activities. They include the cost of goods sold allocable to the receipts and other deductions, expenses or losses that are properly allocable to these receipts.

## What is the QPA Deduction Amount?

The applicable QPA deduction amount has been phased in over a five-year period beginning in tax year 2005.

- In tax years 2005 and 2006, the QPA deduction amount was 3%
- In tax years 2007 through 2009 the percentage increases to 6%
- Beginning in tax year 2010, the percentage will be 9% (6% for certain oil-related qualified production beginning in 2010)

## What are the limitations of the deduction?

The amount allowed as a deduction is limited to 50% of the qualified W-2 reported wages for the year that are allocable to domestic production gross receipts.

## What are the reporting requirements?

The deduction is claimed on Form 8903, "Domestic Production Activities Deduction" and is attached to your tax return.

## The Last Word.

The DPAD is a valuable benefit that can be applied to many industries and specific activities within an even broader population of companies.

The law, of course, is more detailed than provided here, so it's generally worth some analysis and discussion to determine how the DPAD may apply to your organization. For more information about the DPAD or to discuss your organization's other accounting, tax or operational issues, please contact your Sensiba San Filippo team at [info@ssflp.com](mailto:info@ssflp.com) or (925) 271-8700.