

Memo

To: Clients
From: Weber • O'Brien, Ltd.
Re: Domestic Production Deduction

To help offset the repeal of a tax break for U.S. exporters (in response to a World Trade Organization ruling that the tax break—the “extraterritorial income exclusion” –violated international trade laws), Congress created a deduction for U.S. businesses. The deduction, allowed by new Code Sec. 199 for both the regular tax and the alternative minimum tax (AMT), doesn't have an official name. It's been called, among other things, “the U.S. production activities deduction,” the “domestic production deduction,” and the “domestic manufacturing deduction.” For simplicity's sake, we're calling it the Code Sec. 199 deduction.

The Code Sec. 199 deduction is allowed to all taxpayers—individuals, C corporations, farming cooperatives, estates, trusts, and their beneficiaries. The deduction is allowed to partners and the owners of S corporations (not to partnerships or the S corporations themselves), and may be passed through by farming cooperatives to their patrons. And, despite the deduction's history, it's fully available to taxpayers who don't export.

The Code Sec. 199 deduction equals a percentage of the net income from eligible activities—3% in 2005-2006, 6% for 2007-2009, 9% after 2009. However, the amount of the deduction for any tax year may not exceed the taxpayer's taxable income or, in the case of individuals, the taxpayer's adjusted gross income. When fully phased in, the deduction is designed to be economically equivalent to a 3% reduction in the tax rate on eligible activities conducted in the U.S. This means that if the tax rate on the business income from an eligible activity would normally be, say, 36%, the Code Sec. 199 deduction would reduce it (when fully phased in) to 33%. The reduction is smaller before 2010.

In addition, the amount of the Code Sec. 199 deduction can't exceed 50% of the "W-2 wages" (wages subject to income tax withholding, and certain deferred compensation) paid to employees for the year. This means that businesses operated as sole proprietorships or partnerships with no employees aren't eligible for the deduction. (To take advantage of the deduction, such businesses can incorporate and pay W-2 wages to their principals.)

As noted above, the Code Sec. 199 deduction equals a percentage of the net income from eligible activities. Among the more common eligible activities are:

- The manufacture, production, or growth of tangible personal property, in whole or in significant part within the U.S.;
- The construction of real property in the U.S.; and
- The performance of engineering or architectural services in the U.S. in connection with real property construction projects in the U.S.

Purely sales activities aren't eligible for the deduction, nor are purely service activities, except for construction, engineering, and architectural services.

Eligible manufacturing and production activities. A broad range of activities qualifies as eligible manufacturing or production activities. The taxpayer's raw materials and finished products may be brand new, or may be made out of scrap, salvage, or junk material. Manufacturing or producing components used by another party in later manufacturing or production activities are eligible activities, as are manufacturing or producing finished items from components manufactured or produced by others.

The processing and preparation of food products for sale at wholesale is an eligible “production” activity, but the preparation of food and beverages for sale at retail is not.

Generally, the taxpayer must own the property that it's “manufacturing or producing.” The manufacture or production of property under contract for someone else who owns the property isn't an eligible activity. (There are exceptions for some federal government contractors—and this requirement doesn't apply to construction, architecture, or engineering businesses.)

Construction. Construction activities are eligible for the Code Sec. 199 deduction, but only if the construction is of real property performed in the U.S. The real property may consist of residential or commercial buildings, permanent structures (like docks and wharves), permanent land improvements (like swimming pools and parking lots), oil and gas wells, platforms, and pipelines, and infrastructure (like roads, sewers, sidewalks, and power lines). Real property doesn't include machinery unless it's a “structural component”—for an example, an elevator. Examples of businesses conducting eligible construction activities are residential remodelers, commercial and institutional building construction contractors, foundation, structure, and building exterior contractors, structural steel and precast concrete contractors, electrical, plumbing, heating, and air-conditioning contractors.

Eligible construction activities don't include tangential services such as hauling trash and debris, and delivering materials, even if the tangential services are essential for construction.

Construction includes “substantial renovation,” but not decoration (or redecoration).

Engineering and architecture. Engineering and architectural services are eligible for the Code Sec. 199 deduction, but only if they're performed in the U.S. for real property construction projects in the U.S. Eligible engineering services include consultation, investigation, evaluation, planning, design, and supervision of construction. Eligible architectural services include consultation, planning, aesthetic and structural design, and supervision of construction.

There's a lot more to the Code Sec. 199 deduction—for example, determining whether your particular business activities are eligible for the deduction, how to compute the net income from activities that are eligible, and how to determine the amount of the deduction when you've got income from both eligible and ineligible activities. The rules are complicated, and the IRS is still trying to figure out exactly how to apply them.

If you would like to discuss whether the Code Sec. 199 deduction would benefit you, and how to take advantage of it, please do not hesitate to call.