



Deductions for Domestic Production Activities Income

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The 2004 American Jobs Creation Act includes a tax deduction relating to income from certain domestic production activities, effective for taxable years beginning after December 31, 2004 (Section 199 of the Internal Revenue Code (IRC)).

For taxable years beginning in 2005 and 2006, the deduction equals 3% of the lesser of (a) “qualified production activities income” (QPAI) or (b) taxable income for the taxable year. Generally, if a taxpayer is engaged exclusively in the manufacture of qualified production property within the U.S. and has no other sources of income, it is anticipated that QPAI will equal taxable income. The deduction cannot create or increase a net operating loss. The deduction increases to 6% for taxable years beginning in 2007, 2008, and 2009, and 9% beginning after 2009. The deduction for a taxable year is also limited to 50% of the W-2 wages paid by the taxpayer during the calendar year that ends with or within the taxpayer’s taxable year.

Qualified Production Activities

The first step in calculating a company’s Section 199 deduction is to segregate activities among qualified and non-qualified production activities. Qualified production activities consist of:

- The manufacture, production, growth, or extraction in whole or in significant part within the U.S. of tangible personal property (e.g., clothing, goods, food), software development, or music recordings;
- Film production (with exclusions provided in the statute), provided at least 50% of the total compensation relating to the production of the film is compensation for specified production services performed in the U.S.;
- Production of electricity, natural gas, or water in the United States;
- Construction or substantial renovation of real property in the U.S., including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities; and
- Engineering and architectural services performed in the U.S. relating to the construction of real property.

Property will be treated as manufactured by the taxpayer “in significant part” within the United States if: (1) the labor and overhead costs incurred by the taxpayer in the United States for the manufacture, production, growth, and extraction of the property are at least 20% of the taxpayer’s total cost for the property; or (2) based on all of the facts and circumstances, the manufacturing, production, growth, or extraction activity performed by the taxpayer in the United States is substantial in nature (e.g., high raw material cost causes failure of 20% test). To qualify for the deduction, the taxpayer must possess the benefits and burdens of ownership of the tangible personal property. Thus, a contract manufacturer that performs manufacturing activities with respect to tangible personal property owned by another taxpayer does not qualify for the deduction. However, contracts with the Federal government may qualify for the deduction.

Qualified Production Activities Income

The term “qualified production activities income” means “domestic production gross receipts” less allocated cost of goods sold and other deductions. Once a company’s qualified production activities have been identified, the domestic production gross receipts must be computed for each qualified activity. Domestic production gross receipts include gross receipts derived from a sale, lease, rental, license, exchange, or other disposition of tangible personal property manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States (i.e., real property rentals or sales do not qualify).

Domestic production gross receipts also includes the gross receipts from:

- Any lease, rental, license, sale, exchange, or other disposition of a qualified film produced by the taxpayer, or electricity, natural gas, or water produced by the taxpayer in the U.S.
- Construction performed in the U.S.

- Engineering or architectural services performed in the U.S. for production projects in the U.S.

The qualification of the following activities for the deduction deserves special attention:

Construction Activities

Since the statute does not require that gross receipts from construction activities be derived from a lease, rental, license, sale, exchange, or other disposition of the property, a taxpayer engaged in construction activities may qualify for the deduction even if the taxpayer does not possess the benefits and burdens of ownership of the property being constructed. Therefore, more than one taxpayer may be regarded as constructing real property and qualify for the deduction with respect to the same activity and the same construction project.

Preparation of Food or Beverage Activities

Food and beverages prepared at a retail establishment do **not** qualify for the deduction. A *retail* establishment is defined as real property used in the trade or business of selling food or beverages to the public if retail sales occur at the facility. However, food and beverages prepared for *wholesale* distribution would be eligible production activity income. If an establishment has both retail and wholesale activities, the activities will need to be separated. A portion of retail food sales may qualify for the deduction if the establishment produces the sale item (e.g., a bakery that bakes its own bread or a coffee shop that roasts coffee beans used in brewing coffee for retail sale).

Computer Software Activities

In general, income from a lease, rental, license, sale, exchange, or other disposition of software developed in the United States qualifies for the deduction, regardless of whether the customer purchases the software off the shelf or takes delivery of the software by downloading the software from the Internet. However, preliminary

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guidance specifically excludes the following income sources from qualified production activities income:

- Fees for online software use;
- Fees for customer support with respect to computer software;
- Online services;
- Fees for telephone services provided in part through the use of software;
- Fees for playing computer games online; and
- Provider-controlled online access services.

Allocating Cost of Goods Sold and Other Deductions

To compute the domestic production activities deduction, the domestic production gross receipts are reduced by the associated cost of goods sold and by any allocable costs and deductions, to arrive at qualified production activities income.

Under IRS guidance, if a taxpayer cannot specifically identify the related **cost of goods sold**, they may use any reasonable allocation method. However, if the taxpayer uses a method to determine the allocable portion of its gross receipts derived from qualified production activities, the taxpayer must use the same method for determining the allocable cost of goods sold.

The IRS provides three methods for allocating **other deductions** to qualified production activities.

The first method will require taxpayers to: (1) allocate to an item of gross income all expenses directly related to that item of gross income; and then (2) apportion other expenses among all items of gross income on a ratable basis (typically based on a ratio of gross receipts).

The second method is available to taxpayers with average annual gross receipts (over three prior years) of \$25,000,000 or less. It provides a formula that allocates deductions based on the ratio of the taxpayer's receipts derived from qualified production activities compared to the taxpayer's receipts from all sources.

The third method is available to taxpayers with average annual gross receipts of \$5,000,000 or less, and certain other small taxpayers permitted to use the cash method of accounting. This method allows these taxpayers to utilize the same methodology as the second method for determining their other deductions and also allows them to employ the second method for cost of goods sold.

Partnerships and S Corporations

For pass-through entities (partnerships and S corporations) the IRS guidance confirms that the deduction attributable to the qualified production activities of the pass-through entity is determined at the partner or shareholder level. As such, each partner or

shareholder must compute the deduction separately based upon information provided by the pass-through entity.

Affiliated Groups

An "expanded affiliated group" is treated as a single corporation for purposes of applying IRC Sec. 199. An "expanded affiliated group" consists of members of an affiliated group eligible to file a consolidated tax return, except that for purposes of Sec. 199, 50 percent stock ownership is substituted for 80 percent stock ownership and certain excluded corporations are included.

State and Local Tax Effect

The State of Oregon does not conform to IRC Sec. 199. The federal deduction must be added back when arriving at a taxable income (loss) for Oregon purposes.

This bulletin is a summary and is not intended as tax or legal advice. You should consult with your tax advisor to obtain specific advice with respect to your fact pattern.

Based on the most recent "best practice" standards for tax advisors issued by the Treasury Department, commonly referred to as Circular 230, we wish to advise you that this bulletin has not been prepared to be used, and cannot be used, to provide assurance that penalties which may be assessed by the IRS (including specifically section 6662 understatement penalties) will not be upheld.

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