TAXABLE INCOME DEDUCTION FOR UNITED STATES "PRODUCTION" ACTIVITIES

STATUS

The "American Jobs Creation Act of 2004" was signed into law on October 22, 2004 as Public Law 108-357.

The law created a new Internal Revenue Code Section 199. It allows certain taxpayers to reduce their taxable income for a portion of the income they receive from domestic production activities. The IRS refers to the deduction as Domestic Production Activities Deduction (DPAD).

LAW

While there are several significant aspects to DPAD, three are most notable. First, the provision achieves the tax relief not by lowering the tax rate but by reducing the amount of taxable income with a new deduction. (This also means a taxpayer receives the benefit regardless of what rate bracket applies to the taxpayer.) Second, the deduction is not limited to "traditional" manufacturers. Third, the deduction is available to taxpayers regardless of how the business is organized for tax purposes.

Under prior law, there was no provision in the Code that permitted taxpayers to claim a deduction from taxable income attributable to domestic production activities, other than allowable deductions of costs incurred to produce such income.

The law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) for a portion of the lesser of the taxpayer's qualified production activities income (QPAI) or taxable income.

For taxable years beginning in 2005 and 2006, the deduction was three percent of income and, for taxable years beginning in 2007, 2008, and 2009, the deduction was six percent of income. For taxable years beginning after 2009 (and thus currently), the deduction is nine percent of such income. However, the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during the calendar year that ends in such taxable year.

Qualified Production Activities Income

A key definition is what constitutes qualified production activities. While the debate on the relief centered on manufacturing, the definition is more inclusive than just manufacturing. ***Among other items, agricultural and horticultural activity, construction, architectural, and engineering services are qualified activities***. Construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements but not mere cosmetic changes, such as painting.

The first step is to determine “Domestic production gross receipts” (DPGR). These generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States. “Qualifying production property” generally includes any tangible personal property, computer software, or sound recordings.

The next step is to determine “qualified production activities income” (QPAI). QPAI is equal to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income. (Look for extensive regulations by the IRS and Treasury on the allocation of expenses. This is a complicated area.)

For purposes of determining costs, any item or service brought into the United States shall be treated as acquired by purchase, and its cost shall be treated as not less than its value immediately after it entered the United States. A similar rule shall apply in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts.

In the case of any property that had been exported by the taxpayer for further manufacture, the increase in cost or adjusted basis shall not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture.

Domestic product gross receipts also includes (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film produced by the taxpayer; (2) any sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer; (3) construction activities performed in the United States; or (4) engineering or architectural services performed in the United States for construction projects located in the United States.

However, domestic production gross receipts do not include any gross receipts of the taxpayer that are derived from (1) the sale of food or beverages prepared by the taxpayer at a retail establishment, or (2) the transmission or distribution of electricity, natural gas, or potable water. In addition, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed, or rented by the taxpayer for use by any related person.

Other Rules

With respect to domestic production activities of an S corporation, partnership, estate, trust or other pass through entity (other than an agricultural or horticultural cooperative), the deduction under the law generally is determined at the shareholder, partner, or similar level by taking into account at such level the proportionate share of qualified production activities income of the entity.

The Deduction and the Alternative Minimum Tax

Under the alternative minimum tax (AMT) structure certain deductions, credits, allowances, and so forth, taken from regular taxable income are added back into the calculation of taxable income. *The law provides that whether one calculates tax liability based on the regular structure or the AMT, this new production activity deduction is allowed*.

OUTLOOK

Unfortunately, every time the topic of revenue raisers comes up, repeal of Section 199 is mentioned. The initial use was modest and then the recession came along. The full nine percent went into effect for the 2010 tax year so there is no real tax data to indicate how widely it is used.