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Manufacturer's Domestic Production Activities Deduction

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A new domestic production activities deduction (DPAD) is available to manufacturers and is calculated as a percentage of the manufacturer's qualified domestic production activity income (QPAI). For 2005 and 2006, the allowable amount is 3% of QPAI. It then increases to 6% for 2007 through 2009 and 9% for 2010 and later, unless there's a statutory change. Taxpayers and activities that qualify for the deduction are broadly defined. The deduction is claimed on Form 8903, "Domestic Production Activities Deduction," which is attached to the manufacturer's tax return for the year in which the deduction is claimed. For individual taxpayers, this item is a deduction in arriving at adjusted gross income (AGI).

Treasury issued proposed regulations in late 2005, and the final regulations were issued in May 2006. While the final regulations answer many questions raised by taxpayers, they create new issues as well. The regulations are effective for taxable years beginning after June 1, 2006. For taxable years beginning before June 2, 2006, taxpayers may rely on the final regulations or on IRS Notice 2005-14, issued in 2005. The regulations don't address the changes made to the law by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). Some cost allocation methods are provided in the regulations. Normal allocation of income and expenses (for financial accounting statements) by production lines or locations may no longer be sufficient for this purpose, and revised systems may be needed.

The deduction may be limited by the manufacturer's taxable income for the taxable year in which the deduction is claimed. If the taxpayer's taxable income is less than the QPAI, the allowable percentage is multiplied by the taxable income. Thus, the formula becomes: allowable percentage for the year multiplied by the lesser of (1) QPAI or (2) taxable income.

The deduction also is limited to 50% of the manufacturer's W-2 wages. This limitation is intended to discourage outsourcing. For partnerships, guaranteed payments are not W-2 wages. TIPRA limits W-2 wages to those related to qualified manufacturing activities (for tax years beginning after May 17, 2006). Revenue Procedure 2006-22 provides methods for calculating the limitation.

Example 1: In 2006, Company A has taxable income of $10,000,000, QPAI of $8,000,000, and qualified W-2 wages of $1,000,000. Company A is entitled to a domestic production activities deduction of $240,000 (3% × $8,000,000).

Example 2: If Company A's taxable income is $5,000,000, and its QPAI remains at $8,000,000, the limitation applies, and the allowable deduction is $150,000 (3% × $5,000,000).

Example 3: Assume the same facts as in Example 2, but also assume that Company A's qualified W-2 wages were only $200,000. Now the deduction is limited to $100,000 (50% of the taxpayer's W-2 wages).

Manufacturing activities qualifying for this deduction aren't limited to activities of traditional manufacturers. The statutory definition of what qualifies as a production activity is very broad. QPAI is defined as domestic production activities gross receipts (DPGR) less certain deductible items. DPGR includes (1) sales, exchanges, rentals, and other dispositions of qualified production property and goods manufactured, grown, extracted, or produced primarily by the taxpayer (in whole or in significant part) from activities within the United States; (2) construction (excluding self-construction but including engineering and architectural services) performed within the U.S.; (3) qualified domestic film production; and (4) gas, electricity, and portable water produced domestically, excluding income due to the transmission of these utility products. DPGR can also include computer software and processing of agricultural products.

The items deducted from DPGR to arrive at QPAI consist of (1) cost of goods sold, (2) expenses that are directly related to these receipts, and (3) other expenses not directly related to these receipts but that are properly allocated to them on a ratable basis. Accounting systems may need to be revised to keep track of these costs. The final regulations provide that manufacturers can use a reasonable method to allocate cost of goods sold. The cost of goods sold and other costs, however, must be determined by methods used to calculate taxable income, not financial statement income.

A reasonable method must be used to allocate gross receipts between DPGR and non-DPGR. There also is a de minimis safe harbor test. Under this test, if less than 5% of the total gross receipts come from non-DPGR, then all gross receipts may be treated as coming from DPGR.

Services generally don't qualify as domestic production. This may create allocation problems when the services are embedded as part of the product itself. This includes items such as warranties, maintenance agreements, and customer service. If the service is offered only as part of the product cost and never offered as a separate item, however, then allocation isn't required. Even if the service can be purchased separately, the regulations allow a de minimus exception in those instances where it's included as part of the product cost—provided the service portion is worth less than 5% of the product's total selling price.

The deduction isn't limited to corporate manufacturers. Partnerships, limited liability companies (LLCs), S Corporations, sole proprietorships, and other entities engaged in manufacturing, as defined in the regulations, may claim the deduction as well. For passthrough entities (for example, partnerships, LLCs treated as partnerships, S Corporations, and trusts and estates), however, each owner generally must separately compute his or her own deduction by combining the QPAI allocated to the owner from the passthrough entity with his or her QPAI from other sources.

For a partner, the deduction doesn't affect his or her basis in the partnership interest. Each partner is allocated the partner's share of partnership items, such as income, cost of goods sold, and gross receipts that are included in the related items of gross income. For purposes of the deduction, guaranteed payments aren't considered to be allocations of partnership income. To determine a partner's allocation and apportionment of deductions to DPGR and to compute the partner's QPAI, the partner aggregates his or her share of partnership items with items incurred outside the partnership. The final regulations do permit the partnership to compute a partner's share of QPAI at the partnership level instead of allocating the partner's share of partnership items, but the partnership determination must be permitted by the IRS in an IRS Internal Revenue Bulletin.

For purposes of the wage limitation, a partner's share of the partnership's W-2 wages is the lesser of the partner's allocable share of the wages, or two times 3% of the QPAI computed by taking into account only the partnership items that are allocated to the partner for the taxable year. With respect to the partnership's allocating W-2 wages to partners, the wages must be allocated in the same manner as wage expense. Rules similar to those described for partners also apply to shareholders of an S Corporation and members of an LLC treated as a partnership. ■

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