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legal update



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Tax Savings for Domestic Production Activities

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The 2004 tax legislation created a new tax deduction for Income Attributable to Domestic Production Activities (DPAD). This is an income tax deduction of 9% (phased-in at 3% for 2006 and 6% for 2007 through 2009) from the income a manufacturer recognizes from domestic production. The DPAD is available to all forms of business entities and to individuals that domestically manufacture products. Many businesses, which would not typically be considered manufacturers, will be considered manufacturers under the provisions of the DPAD. Therefore, a careful analysis of your business may uncover planning opportunities to minimize your tax liability.

Activities that qualify for the DPAD include leasing, renting, licensing, selling, or exchanging any tangible personal property that is manufactured in the United States. The DPAD also includes income from software developed domestically and construction performed in the U.S., along with any engineering and architectural services performed for domestic construction projects. The IRS does not require the manufacturer to complete the entire manufacturing process, only that the property is manufactured "in significant part" via the manufacturer in the United States. This "significant part" applies not to the value added via the manufacturing, but to the amount of production the manufacturer puts into the product.

The DPAD is calculated by separating the income and expenses derived from production activities from the income and expenses derived from non-production activities. The amount deducted from the taxpayer's taxable income is the net of the income derived from the production activities less the production expenses, and multiplied by the applicable deduction percentage (3% for 2006).

The DPAD does come with limitations. The DPAD is capped at one-half of the wages paid to employees, as reported on W-2 forms. Additionally, the amount of income from production activities to which the deduction applies is capped at the total amount of taxable income for the year.

For example, Jeweler is the sole owner of a jewelry store that sells jewelry and does a fair amount of business in making custom necklaces. Jeweler imports precious metals and stones from international dealers. The jewelry store has \$150,000 per year of taxable income. Jeweler receives \$100,000 of revenue per year from orders for custom necklaces. To fill those orders, Jeweler pays \$20,000 for raw materials, \$20,000 in wages, and has \$10,000 of allocated overhead. Jeweler's resulting net income from domestic production is \$50,000. The DPAD will be \$1,500 for 2006, \$3,000 for years 2007 to 2009, and \$4,500 per year for 2010 and beyond. The W-2 wages paid to employees is \$20,000.

Because one-half of the \$20,000 of W-2 wages (\$10,000) exceeds each of the DPAD deduction amounts, the wage limit does not affect Jeweler. Because the income from production activities (\$50,000) is less than the \$150,000 of taxable income, this limit does not affect Jeweler, either.

Assume that Jeweler has a banner year after getting publicity for fine craftsmanship and receives orders from the Internet totaling \$1,000,000 of revenue from orders for custom necklaces. Jeweler's raw material costs increase to \$150,000, wages increase to \$100,000, and the allocation of overhead increases to \$50,000. Now, Jeweler's net income from domestic production is \$700,000 and the maximum DPAD (for years 2010 and beyond) is \$63,000. Because this amount of DPAD would exceed one-half of the wages paid (\$50,000), Jeweler will lose \$13,000 of this deduction. If Jeweler had created an S Corporation and paid himself a salary for his work, his entity's W-2 wages would be increased and this deduction would not have been lost.

As with most tax provisions, there are myriad complexities to these rules. However, there are also planning opportunities. The first step in taking advantage of the DPAD is understanding how it works. The deduction only applies to the net income from certain activities, so tax planning may enable the taxpayer to increase the income allocated to production activities and lower the income allocated to the non-production activities of the business. Likewise, planning may be used to decrease the expenses allocated to production activities and increase the expenses allocated to non-production activities. Additionally, tax planning may help you avoid losing part of the deduction to one of the caps.

We urge you to contact us to assist you in maximizing the tax benefit you can obtain from the DPAD.