

## The Domestic Production Activities Tax Deduction

The purpose of this article is to provide information about the tax benefits available under Section 199 of the Internal Revenue Code. Section 199 allows a special tax deduction to qualified taxpayers involved in certain domestic production activities. The deduction applies to all taxpayers, including individuals, corporations, and estates, trusts, along with their beneficiaries as well as partners and the owners of S corporations.

In general, the deduction equals a percentage of the net income derived from eligible activities—3% in 2005-2006, 6% for 2007-2009, 9% after 2009. However, the amount of the deduction for any tax year cannot exceed the taxpayer's taxable income or, in the case of individuals, the taxpayer's adjusted gross income. And, the 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 sole proprietorships or partnerships that operate without employees aren't qualified for the deduction. (To take the deduction, such proprietorships or partnerships may want to consider incorporating and then pay qualified wages to their principals).

As noted, the deduction equals a percentage of the net income from eligible activities. These activities would include:

- 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 and purely service activities are ineligible for the deduction, unless the nature of the services is for construction, engineering, and architectural activities.

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

The rules state that generally, the taxpayer must own the property that it is "manufacturing or producing." In other words, while there are some exceptions for certain federal government contractors, production activities performed under a contract for someone who owns the property is not an eligible activity.

Construction activities are eligible for the 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 (akin to docks and wharves), permanent land improvements (such as 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 is 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 do not include tangential services such as moving rubble, and delivering supplies, even if the services are essential for construction.

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

Engineering and architectural services qualify for the deduction, but only if they are performed in the U.S. for real property construction projects in the U.S. Eligible engineering services consist of consultation, investigation, evaluation, planning, design, and management of projects. Eligible architectural services include consultation, planning, aesthetic and structural design, and supervision of construction.

There is much more to the deduction under Section 199. The rules are complicated. Although highly technical, the instructions issued by the IRS to Form 8903, Domestic Production Activities Deduction, provide some guidance on the often convoluted computations.

If you would like to discuss whether the Section 199 deduction would benefit you please do not hesitate to call Vincent Ruocco, LLC, CPA at 203.932.2931 or [vruocco@artcpas.com](mailto:vruocco@artcpas.com).

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