

# Making Taxable Income Disappear

## *The Domestic Production Activities Deduction*



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By Pat O'Hara, EA, CTC

**T**he economy is changing, and more small businesses are emerging to fill the void left by corporate downsizing. Entrepreneurs are using their skills to add value to products and services and find ways to compete in the global marketplace while maintaining profitability. One of the most important business strategies that is often overlooked is how to plan for and manage tax liability. Small-business owners should never forget the maxim, “A dollar saved in tax is worth more than a dollar earned.”

How can business owners find out what little-known deductions can offset their tax liability? It is worthy of some investigation. I often remind my clients that Congress put deductions, credits, and loopholes in the tax code to promote small business because it is the foundation of our economy. One of the most misunderstood deductions is the Section 199 “Domestic Production Activities Deduction,” or DPAD for short. If you have never heard of this deduction, you are not alone. I am always surprised when colleagues tell me they have never heard of it because this deduction even has its own line on the front page of the tax return. It is equally disturbing when I learn that a taxpayer has either been told they don’t qualify for the deduction, or that it is too time consuming to claim and is not worth pursuing. How could potentially

lowering your taxable income by 9% not be worth pursuing? A good tax detective will inspect your business to see if this deduction can be spied out for you.

I will admit that this deduction is a little intimidating, but it gets much easier to understand once you get past the bulky terms and acronyms. Fortunately, there are Certified Tax Coaches that specialize in this area of tax planning that can help you determine if your business is eligible for this deduction, show you how to properly structure your business transactions so you meet all of the requirements, and determine the best method to calculate the deduction to maximize your savings. Let's examine the case of the missing DPAD.

## Congress Created This Deduction to Promote Small Businesses

The Domestic Production Activities Deduction (DPAD) was added to Section 199 of the tax code as part of the *American Jobs Creation Act of 2004* as a way to ease the tax burden on domestic producers and manufacturers. Congress created this incentive for goods to be “Manufactured, Produced, Grown, or Extracted (MPGE)” in the United States while promoting employment. Aside from traditional manufacturing, it also promotes construction, engineering, and architectural services performed in the US for construction in the US. Qualifying for the deduction requires the business to pay W-2 wages rather than subcontracting out the labor. The deduction may be taken by individuals, partnerships, corporations, and even some trusts and estates, and it allows for the exclusion of income from taxation.

Starting in 2009, the deduction increased to 9% of qualifying production activities income. In simple math terms, if your qualifying net income is \$100,000, your deduction is \$9,000. For a taxpayer in the 25% marginal tax bracket, this equates to tax savings of \$2,570 or more. The most difficult part of claiming DPAD is determining what income qualifies for the deduction. This task is best left to your Certified Tax Coach. Your concern should be focused on what to do with all

of the money you are going to save from claiming this deduction this year and every year going forward.

What makes DPAD so important for tax planning is that, for most small-business taxpayers, the deduction is an adjustment to income on their personal income tax return. This deduction lowers the taxpayer's adjusted gross income (AGI). We sometimes call this an above-the-line tax deduction. Marginal tax rates, Alternative Minimum Tax (AMT), the new Net Investment Income Tax (NII), and many tax credits are affected by AGI. In short, lowering AGI on the personal return can yield big savings by lowering the marginal tax rate and increasing eligibility for certain tax credits. This deduction becomes even more valuable as tax rates for individuals continue to rise.

## The Basics of DPAD

We said earlier that the basics of this deduction are qualifying income from goods Manufactured, Produced, Grown, or Extracted (MPGE) in the United States while promoting employment. These activities result in creating Qualified Production Property (QPP). This property can be leased, rented, licensed, sold, or exchanged to qualify. MPGE includes developing, improving, and creating QPP out of raw materials, scrap, salvage, or junk, or by changing the form and function of an article. These can be items that are produced on a factory assembly line or are handmade. The DPAD applies to farming activities such as cultivating soil, growing crops, raising livestock, and repurposing waste products. In terms of salvage operations, it could be something as simple as shredding old tires and creating a new form of raw materials for further manufacture. It may also apply to fishing and to mining for minerals and other natural resources. Even qualified films or TV productions, electricity, natural gas, or potable water produced in the US qualify.

DPAD also includes construction, as well as engineering and architectural services performed in the US for construction projects in the US. This means that most residential and commercial contractors,

subcontractors, and developers of any original construction or capital improvement projects may qualify for this deduction. We are talking about carpenters, electricians, plumbing and heating contractors, masons, excavators, and all other building trades involved in constructing or improving real property. The determination of qualifying activities is performed on an item-by-item basis, which essentially means that for purposes of claiming the deduction, each qualifying job must be looked at separately. Although there are many rules, a Certified Tax Coach is in the best position to determine if you qualify.

## Does Your Business Qualify for the Deduction?

The range of businesses that qualify for DPAD is much wider than most people think. One might think that this deduction only applies to big manufacturing businesses, but with a skillful understanding of the tax code, legislative intent, and court cases, many other businesses that make or add value to things may also claim this tax-saving deduction. What is important to note is that the courts seem to be taking a very broad interpretation on the application of this deduction based on legislative intent, provided the taxpayer meets certain tests under the law. In my practice, we apply this deduction to a variety of small businesses including building contractors; farming and florists; businesses that make furniture, wine, or cheese; wholesale food-service operations; print shops; and recycling operations that transform or repurpose scrap materials. Although professional services would not generally qualify, some aspects of their services may. Examples could be an eye doctor who custom-makes eye wear, grinding lenses and assembling them into frames. It may also apply to a compounding pharmacist who has to mix or transform medications for special use.

Recent court cases have expanded the interpretation of what types of activities qualify for this deduction. One of the most notable cases involved a business that made custom gift baskets.<sup>1</sup> The company basically took items that are normally sold by other retailers and packaged

them into gift baskets and resold them. In short, the value of the completed basket was higher than the cost of its contents. The court found that this creation of value, or the process that created it, is what qualifies it for DPAD. A similar ruling by the IRS Office of Chief Counsel also noted that photo processing in a retail pharmacy qualifies when the taxpayer uses his own raw materials (photo paper, ink, and other chemicals) to produce a different tangible product in form and function.<sup>2</sup> In the area of construction, the courts found that a substantial renovation of property qualified because it materially increased the value of the property and substantially prolonged its useful life.<sup>3</sup>

## Who Is Taking the Deduction?

Federal statistics show that two thirds of businesses taking this deduction are in the manufacturing sector. Manufacturing generally refers to building personal property for resale—items such as clothing, furniture, computer components, jewelry, and so on. The second-largest sector taking the deduction is information technology, particularly with the development of computer software, including packaged software, gaming software, and some other software that is available through download.<sup>4</sup> This deduction may also be available to the growing segment of app developers.

Keep in mind that the reason manufacturing and IT companies represent the majority of this deduction is because these industries are often controlled by large conglomerates. Small businesses that currently don't qualify probably could with some simple restructuring. It is important to note that many non-manufacturing small businesses may benefit most from this deduction: they have the advantage of using much simpler methods to calculate DPAD, and generally, if using a cash-basis accounting system, may not have to capitalize costs as required by larger businesses.

The construction industry may be the biggest benefactor of this deduction in coming years as residential and commercial construction increases. Generally, all of the capital costs of new construction,

associated excavation, engineering and architectural planning qualify for the deduction provided they occur in the US. Many capital improvement projects also qualify. These include improvements that become structural components of the property, increase the property's value, change its purpose, or extend its useful life. On the contrary, activities that solely include maintenance and repair would not qualify.

Most income from farming and agricultural activities also qualifies for the deduction. This includes most of the income reported on Schedule F, such as crop revenue, other farm-related income, and gains from the sale of raised breeding, dairy, or draft livestock. Dairy farms, or their subsidiaries that process milk products, also qualify. Farms that raise cattle for slaughter and conduct their own butchering activities such as grinding, smoking, or curing meats may also qualify.

## Food Service Industry Exception

One of the exceptions to DPAD is the food service industry. The gross receipts of food and beverages prepared at a retail establishment don't qualify for DPAD. However, a food service that prepares food and sells it wholesale may be eligible to take the deduction. For example, we worked with a caterer who prepared pre-packaged sandwiches and salads that were sold to convenience stores for resale. The income from this activity qualified for DPAD, but their regular catering activities generally didn't. We had a similar case with a pizzeria that had contracted with a local school to produce pizzas for resale to students. The income from selling the pizza to the schools qualified for DPAD, but the pizzas sold out of their shop didn't. Similarly, the bakery selling its products on site didn't qualify, but items that were shipped out to retailers were eligible for the deduction. Some food service businesses are restructuring to have one business prepare food at one location and then sell it wholesale to a subsidiary for resale at another location.

## Paying Wages

The requirement of paying wages is the deciding factor in claiming DPAD. The deduction is limited to 50% of allocable wages. These are wages that can be allocated to the domestic production gross receipts (DPGR). These must also be wages that are subject to employment taxes, which means that wages paid to minor children that are exempt from employment taxes, or wages paid in commodities (a great loophole for farmers), don't qualify for purposes of DPAD.

Many small businesses don't pay wages and prefer to use subcontractors or family members. DPAD can be a way to offset the cost of putting employees on payroll. Adding formal employees to the business may help a business grow and even provide for an exit strategy as the small-business owner turns the day-to-day operation over to employees. Shifting income to family members in a lower tax bracket is a solid strategy. Paying wages to a spouse creates eligibility for a Section 105 Medical Reimbursement Plan, and, more importantly for the otherwise non-working spouse, wages can also create eligibility for Social Security, Medicare, and survivor's benefits.

## Terms You Need to Know

The following terms define the rules for determining the DPAD. They are big, bulky, and sometimes annoying to read out loud—but the tax savings are generally well worth the effort.

**Qualified Production Activities Income (QPAI)** is the amount equal to Domestic Production Gross Receipts (DPGR) less the allocable Cost of Goods Sold (COGS) less other properly allocable direct and indirect costs.

**Domestic Production Gross Receipts (DPGR)** are the gross receipts derived from the active conduct of a trade or business; construction of real property; the active conduct of an engineering or architectural service trade or business with respect to the construction of real property; and/or the subsequent sale or lease of Qualified Production

Property (QPP) to the taxpayer who originally manufactured, produced, grew, or extracted (MPGE) the qualified production property (QPP) within the US.

**Qualified Production Property (QPP)** is considered tangible personal property, computer software, and sound recordings.<sup>5</sup> The definition for DPAD purposes may be different from state law. For instance, tangible personal property does not include land, buildings, inherently permanent structures, land improvements, or oil and gas wells and infrastructure. For DPAD purposes, machinery, printing presses, transportation equipment, office equipment, refrigerators, grocery counters, testing equipment, display racks, and shelves and signs contained in or attached to a building are tangible property.

## Calculating the Deduction

The DPAD involves some very simple math. All that needs to be done is to calculate 9% of Qualified Production Activities Income (QPAI). QPAI is computed by deducting the cost of goods sold, and direct and indirect expenses from DPGR. Remember that these terms may sound menacing, but they just represent special definitions that carry special rules. A Certified Tax Coach can show you how they work.

The tax code provides three different methods for calculating the deductions. Small-business owners have the advantage of being able to choose any of the three methods, and the taxpayer can change methods each year, choosing the one that yields the highest deduction. I tend to believe that the smaller the business, the easier it is to take this deduction.

- The Small Business Simplified Overall Method (SOM) is for taxpayers with less than \$5 million in average annual gross receipts, some farmers, and taxpayers eligible to use the cash basis of accounting.<sup>6</sup> The SOM allows the taxpayer to allocate direct and indirect costs based on the ratio of DPGR and non-DPGR. This is the easiest method for small businesses.



- The Simplified Deduction Method (SDM) is for taxpayers with less than \$100 million in average annual gross receipts or \$10 million in total assets.<sup>7</sup> The SDM requires that the taxpayer determine the proper amount of costs of goods sold to allocate to DPGR and then apportion other costs between DPGR and non-DPGR. This method requires a little more research, but can sometimes yield a higher deduction than the SOM.
- The Section 861 Method may be used by any taxpayer and is the most complex method as it requires the taxpayer to specifically identify and trace the cost of goods sold (COGS) to different classes of income, and then allocate its other deductions to relevant classes of income and expenses. Unless required by law, only businesses with the most sophisticated cost accounting systems would use this method. It is a very detailed item-by-item analysis of qualifying revenue and job costs. In some cases, this method may yield the highest deduction.

## Examples of Applying the Different Methods

A printing company provides a variety of services, including printing simple copies, custom cutting, folding, and, at times, binding materials. Activities that involve a process that changes the form and function of the paper, such as cutting, folding, or binding, qualify for the deduction—provided all other tests for the deduction are met. For the purpose of this example, let's say that a company's gross receipts for the year were \$1,000,000, of which \$850,000 involved production processes beyond simple copying. The cost of goods sold was \$250,000 and the indirect costs were \$100,000.

Using the Small Business Simplified Overall Method (SOM), we see that the production revenue was 85% of the total revenue. We would use the 85% of the gross receipts less 85% of COGS, less 85% of indirect costs to get our Qualified Production Activities Income (QPAI). This would be \$850,000 less \$212,500 of costs of goods sold (\$250,000 times 85%) less 85,000 in direct costs (\$100,000 times 85%), which would

equal QPAI of \$552,500. The deduction would be 9% of \$552,500, or \$49,725, subject to the 50% of W-2 wages rule.

Using the Simplified Deduction Method (SDM) we would take the \$850,000 in production revenue and subtract the actual cost of goods sold, say \$250,000, less the actual allocable indirect costs, say \$25,000. This would give us QPAI of \$585,000. The deduction would be 9% of \$585,000, or \$52,650, subject to the 50% of W-2 wages rule.

Using the Section 861 Method we would go back and look at each print job and calculate the combined DPGR, COGS, and allocable indirect costs. In theory, this method should give us a result very similar to the SDM, but the requirement to capitalize costs may shift the numbers a bit.

The point here is that the easiest method isn't always the biggest deduction. A good accounting system is the best way to ensure that the deduction is maximized. The taxpayer must also have a reasonable basis for his accounting system and allocations of DPGR, COGS, and indirect costs and be consistent in its application.

## DPAD Is Not an Election

One of the great aspects of DPAD is that it is not considered an election, meaning that if you fail to take the deduction, you can still go back and claim it within the three-year statute of limitations for filing an amended return. It is also important to note that although we call it an allocation "method," it is not considered an "accounting method" that requires IRS approval to change. The fact that DPAD is not an election means that once an allocation method is chosen it can still be changed from year to year. Thus, if you took the SOM this year, you can take the SDM next year. You could even change the method on an amended return if it made a significant difference. This means that there is a lot of flexibility for those who take advantage of this great deduction.

## There Are Some Limitations

The DPAD is not recognized by all states, so although the IRS allows the adjustment to income for federal purposes, it may not be allowed under state law.

DPAD may only be taken by one taxpayer in the process and is generally the one that originally manufactured, produced, grew, or extracted the Qualified Production Property in the US, and/or had the benefits and burdens of ownership during the process. It is important for the taxpayer to clarify, in any contracts with suppliers or contractors, who is entitled to take the deduction and with respect to all aspects of the production process.

Taking the deduction requires that production be completed in “whole or in significant part within the US.” The IRS has a safe harbor interpretation that roughly translates into a 20% threshold of the direct labor and overhead costs being incurred in the US.

Gross receipts from warranties, delivery, operating manuals, installation, or service agreements are not considered DPGR when these charges are separately-stated or sold independently. When revenue from these activities is 5% or less of the total gross receipts, they are considered *de minimis* and are included in DPGR.

## Real-Life Examples

### The Electrical Contractor

A local electrical contractor was referred to me by his investment advisor. He was concerned because after paying estimated taxes each quarter he had nothing left to fund their Simplified Employee Pension. The business pre-wires new homes, installs standby power systems, provides service contracts, and performs general repair services. One of the strategies we used to lower taxes was DPAD. DPAD saved the client about \$5,000 a year in tax, and in conjunction with the strategies we used we were able to lower his

adjusted gross income from \$220,000 to just under \$160,000, making him eligible to claim the American Opportunity Tax Credit for his two college-age children. We also went back and amended returns for the three prior years allowed and reclaimed DPAD. All told, we saved the client about \$62,000 in the first year.

### **The HVAC Contractor**

An HVAC contractor contacted our firm about tax planning. We reviewed his business model to see if he would qualify for DPAD and found that he did not. Although the company was installing equipment that would otherwise qualify for the credit, it was ineligible because its customers bought the equipment elsewhere—the company was install-only. We suggested that he restructure his transactions and actually buy the HVAC equipment, then sell it to the customer as part of the capital-improvement project. Once he had the benefits and burden of the inventory being used, he qualified. He found that buying the equipment himself allowed him to negotiate a lower price from the vendor and get a markup on the materials sold. Customers saved on the sales tax. The contractor's revenue doubled, profitability increased by about 25%, and he was able to cut his tax bill by about 10%.

### **The Farmer**

A family-run farm sells a variety of farm products, including trees, seasonal fruits and vegetables, hay, and shearings from sheep and alpaca. The owner was aware of DPAD, but knew he didn't qualify because he didn't have any employees. When we asked the farmer why he didn't put his wife and five kids on the payroll, he said he didn't want to pay \$600 per year to the payroll company. We explained that putting his kids on payroll would cut his personal taxes by 50 cents for every dollar paid in wages. We also showed him how the wages paid to his two adult children would qualify him for DPAD. Our recommendations yielded about \$40,000 in tax savings.

## The Computer Company

I offered a free mini tax-planning session to my computer vendor several times over a couple of years. He always told me he liked to do his own taxes using a popular off-the-shelf tax software. When he finally met with me, we discovered he was not claiming DPAD on his income from custom-building computer systems. Furthermore, we discovered that off-the-shelf software either didn't handle the deduction or didn't prompt the taxpayer to claim it. When we reviewed the deduction, we calculated that he was entitled to a deduction of about \$22,500 in the current year, which equated to a savings of about \$5,625. When we went back and amended three years of returns, we found over \$20,000 in savings related to DPAD.

## The Real-Estate Developer

A real-estate developer purchased 30 acres of land and built 10 homes. The cost of the project included the costs to subdivide, excavate, build roads, and build the houses. All of the houses were substantially similar. Tax rules require that the costs of the project be capitalized. As each home sold, the selling price represented the DPGR, and the allocated costs, determined by the Section 861 Method, determined the QPAI, which multiplied by 9% equals the deduction. The deduction for each year is based on an item-by-item basis, whereby the calculation of the sale of each house is done separately taking into account the sales price, capitalized costs of goods sold, and any indirect costs associated with the sale. Interestingly, as the price of the unsold homes increases, so does the potential deduction, which going forward can help offset costs and any depreciation recapture.

## Don't Try to Be Your Own Private Eye

If you have gotten this far, you have learned that DPAD is a great deduction for small businesses that qualify. I have illustrated this chapter in terms as easy as possible. Although the actual math involved in the calculation of the deduction is quite simple, it is important to

recognize that the rules for applying this deduction may be complicated and may best be left to a qualified professional.

DPAD is a very complicated section of the tax code because it hasn't been thoroughly defined by the IRS and is just beginning to be tested in court. IRS policy points to a broad interpretation of the application of DPAD, but at the same time the IRS recognizes the need for heavy scrutiny to deter fraud.

Maintaining an accurate accounting system is essential to maximizing the Section 199 deduction. It is very important to develop a consistent basis for separating qualifying receipts from those that are not. Understanding and properly accounting for the direct and indirect expenses associated with this deduction are also important. Separating indirect costs is likely to increase the deduction but requires an item-by-item cost accounting method. Restructuring transactions to include purchasing materials to meet the "Benefits and Burdens of Ownership" test and evaluating the use of W-2 employees instead of subcontracting work also require continual review to meet the strict guidelines. Many clients find that retaining their Certified Tax Coach under an annual service contract is the most efficient way to maximize the deduction and meet the requirements of the law.

## Let's Review Our Clues:

- Small-business owners must manage tax liability to compete in the global marketplace while maintaining profitability.
- The Domestic Production Activities Deduction (DPAD) is a little-known yet highly valuable deduction for goods that are manufactured, produced, grown, or extracted in the United States while promoting employment.
- The DPAD applies to many farming activities and may apply to fishing and to mining for minerals and other natural re-sources. Qualified films or TV productions, electricity, natural gas, or potable water produced in the US qualify. DPAD also includes construction, engineering, and

architectural services performed in the US for construction projects in the US.

- The requirement of paying wages is the deciding factor in claiming DPAD.
- The range of businesses that qualify for DPAD is much wider than most people think.
- Calculating the deduction for DPAD can be done with three methods: the Small Business Simplified Overall Method (SOM), the Simplified Deduction Method (SDM), or the Section 861 Method. They most often yield different deduction amounts, so you will want to use the method that works best for your business.
- You reclaim DPAD within the three-year statute of limitations for filing an amended return.
- DPAD is not recognized by all states, so although the IRS allows the adjustment to income for federal purposes it may not be allowed under state law.
- Finding a Certified Tax Coach that understands the rules of this Section 199 deduction can generate significant tax savings for you without creating additional expenses.

Be a savvy sleuth and take your case to the pros to see if you can take advantage of the DPAD.

### **Endnotes**

- 1 U.S. v. Dean, et al (112 AFTR 2d 2013-5592)
- 2 FAA 20133302F
- 3 Gibson & Associates, Inc. 136 TC No.10
- 4 Reg. 1.199-3(i)(6)(iii)(B); CCA 201226025
- 5 Reg. 1-199-3(j)(1)
- 6 Rev Proc 2002-28; Reg. 1.199-4(f)
- 7 Reg. 1.99-4(e)

## ABOUT THE AUTHOR

**Pat O'Hara, EA, CTC**

**I**solve tax problems! As a Certified Tax Coach, I help small-business owners pay less tax and have more money available to reinvest in their businesses, find money to save for retirement, or just have more money to do the things they want to do.



I work with building contractors, farmers, winemakers, caterers, small manufacturers, and craftsman in New York's Hudson Valley, and show them how to take advantage of tax incentives that most tax professionals miss or don't understand how to apply. One of the most missed deductions for these types of business owners is the subject of my chapter.

Too many clients come to me because they are in trouble with the IRS or state tax authorities. As an Enrolled Agent and Fellow of the National Tax Practice Institute, I have a reputation for resolving tax controversy. Most small businesses get into tax trouble because they don't plan to pay less tax and don't know how to take advantage of favorable provisions in the tax code. I became a Certified Tax Coach to help my clients reduce their tax burden before problems arise.

In 24 years helping people solve tax problems, I have seen more workers become small-business owners. Many of these business owners are stunned to find they end up paying 50% or more in tax on their hard-earned income. I develop tax-saving strategies that best utilize deductions, credits, and loopholes to prevent this from happening. Many of my clients find tax savings of \$10,000 or more in the first year. My clients have realized that good tax planning is life changing and sets them onto the path to greater profitability and financial security.

Unlike many tax professionals, I take the time to learn about my clients' businesses and see firsthand how they earn their income. I enjoy



touring their facilities and learning their work processes. I review their prior-year returns and put together a comprehensive tax plan with multiple strategies to reduce their income taxes and mitigate the risk of audit. I also help my clients choose the best strategies to implement, so they see an immediate return on their tax-planning investment.

If you would like to learn more, look for me on LinkedIn or Google at “Tax Alternative Group, LLC.” You are also welcome to sign up for my free weekly Personal Strategy Notes at [patrickohara.mylocaltaxpro.com](http://patrickohara.mylocaltaxpro.com).

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