



The Domestic Production Deduction Is Here

A broad range of U.S. taxpayers will see an important change this year, as one set of incentives starts phasing out and another begins to take effect.

In prior years, the foreign sales corporation (FSC) and extraterritorial income (ETI) deductions rewarded companies that created jobs in the manufacture of products for export. But the World Trade Organization (WTO) ruled that the ETI and FSC programs constituted an unfair government subsidy, and Congress voted to end them. (A third export incentive remains — the Interest-Charge Domestic International Sales Corporation, or IC-DISC — but only for such entities already established. New DISCs cannot be set up.)

The lawmakers also enacted the American Jobs Creation Act, which offers a new deduction to companies that manufacture products for sale, perform construction in the U.S., or perform engineering and architectural services in the U.S. for U.S. projects.

The new domestic production deduction (DPD) is unconcerned about whether the goods created are bound for domestic or foreign markets. The purposes of the deduction were to spur job growth in the construction and manufacturing segments and address the illegality of the ETI and FSC programs as determined by the WTO.

By taking full advantage of this new deduction, a company can reduce its effective tax rate by three percentage points (for example, from 34% to 31%) The deduction will gradually increase to its maximum in 2010, as shown in the accompanying sidebar.

Broader Tax Incentives to Create Jobs

The new tax law was designed to offer tax incentives to a much broader range of companies than the old export programs did. And though the new deduction itself is lower than the old one, it's calculated on a larger base — a company's entire domestic production income.

But the meaning of the new Act has not been fully clarified, and the IRS is working on additional guidance to be issued shortly.

Determining What's Qualified and What's Not

Two new concepts are central to determining a company's tax deductions under the new Act.

One is qualified production activities income, or QPAI, which the IRS defines as a company's gross receipts for domestic production minus the costs, deductions, expenses and losses allocable to such receipts, and minus the ratable portion of deductions, expenses and losses not directly allocable to any class of income.

The second new concept is domestic production gross receipts, or DPGR, which refers to the receipts a company derives from its disposition of qualified production property — defined as any tangible personal property, computer software and certain sound recordings — produced in the U.S. The DPGR definition also includes certain construction, engineering and architectural related services performed in the U.S. It excludes most retail food and beverage production, energy transmissions and property used by a person related to the taxpayer.

Taxpayers can choose among several options to calculate the deduction (see sidebar). For most, the initial challenge will involve classifying production activities and measuring the income and costs that result from those activities.

Simplify, Simplify

Calculating the new deduction will be an easier one for many companies. While the distinction between DPGR and non-DPGR costs is the same for all taxpayers, the allocation and apportionment of expenses associated with DPGR and non-DPGR can be simplified depending on a taxpayer's gross receipts. Companies with receipts greater than \$25 million can use the same allocation rules under current IRC 861. Taxpayers with gross receipts less than \$25 million have options.

The domestic production deduction is taken at the corporate level by C corporations and at the individual level for income generated by such “pass-through” entities as S corporations and partnerships. The IRS has not yet provided guidance on what documentation the filing will require; Form 8903 exists in draft form.

Most companies that are losing an export deduction will be eligible for the DPD, but they won't find a simple equivalence. To obtain the optimum deduction, they'll need a close analysis of their production operations, receipts and costs.

We can help you understand the DPD, how it affects your taxes and how to leverage it to produce the best results. Give us a call for more details.