

Washington Tax Report

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Deduction for Domestic Production Activities Income

Introduction

On October 22, 2004, President Bush signed into law the American Jobs Creation Act, which includes a tax deduction relating to income from certain domestic production activities, effective for taxable years beginning after December 31, 2004 (Section 199 of the Internal Revenue Code (IRC)). Please refer to our November 2004 Washington Tax Report for a summary of the American Jobs Creation Act of 2004.

On January 19, 2005, the U.S. Treasury Department (Treasury) and Internal Revenue Service (IRS) issued Notice 2005-14 with respect to IRC Sec. 199 and a Fact Sheet regarding this Notice. The IRS issued proposed regulations under Section 199 on October 20, 2005, and final regulations on May 24, 2006. Legislative amendments were further made to the domestic production activities deduction by the Tax Technical Corrections Act of 2005 and the Tax Increase Prevention and Reconciliation Act of 2005.

For taxable years beginning in 2005 and 2006, the deduction equals 3 percent of the lesser of (a) qualified production activities income or (b) taxable income for the taxable year. Thus, the deduction cannot create a net operating loss. The deduction increases to 6 percent for taxable years beginning in 2007, 2008 and 2009, and 9 percent for taxable years beginning after 2009. However, the deduction for a taxable year is limited to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends with or within the taxpayer's taxable year. W-2 wages are wages paid to common law employees. For taxable years beginning after May 17, 2006, only W-2 wages attributable to the qualified production activities can be taken into account. The IRS Regulations provide alternative methods for computing W-2 wages.

Qualified Production Activities

The first step in calculating a company's domestic production activities deduction is to segregate activities among qualified and non-qualified production activities. Qualified production activities consist of:

- The manufacture, production, growth or extraction in whole or in significant part within the United States of tangible personal property (e.g., clothing, goods and food), software development or music recordings.
- Film production (with exclusions provided in the statute), provided at least 50 percent of the total compensation relating to the production of the film is compensation for specified production services performed in the United States.
- Production of electricity, natural gas or water in the United States.
- Construction or substantial renovation of real property in the United States, including residential and commercial buildings and infrastructure such as roads, power lines, water systems and communications facilities.
- Engineering and architectural services performed in the United States and relating to the construction of real property.

Qualified Production Activities Income

The term "qualified production activities income" means "domestic production gross receipts" less allocated cost of goods sold and other deductions. Once a company's qualified production activities have been identified, the domestic production gross receipts must be computed for each qualified activity. Domestic production gross receipts include gross receipts derived from a lease, rental, license, sale, exchange or other disposition of tangible personal property manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States. Property will be treated as manufactured by the taxpayer "in significant part" within the United States if: (1) based on all of the facts and circum-

stances, the manufacturing, production, growth, or extraction activity performed by the taxpayer in the United States is substantial in nature; or (2) the labor and overhead costs incurred by the taxpayer in the United States for the manufacture, production, growth and extraction of the property are at least 20 percent of the taxpayer's total cost for the property. To qualify for the deduction, the taxpayer must possess the benefits and burdens of ownership of the tangible personal property. Thus, a contract manufacturer that performs manufacturing activities with respect to tangible personal property owned by another taxpayer does not qualify for the deduction. However, contracts with the Federal government may qualify for the deduction.

Domestic production gross receipts also includes the gross receipts derived from:

- Any lease, rental, license, sale, exchange or other disposition of a qualified film produced by the taxpayer, or electricity, natural gas, or water produced by the taxpayer in the United States.
- Construction performed in the United States.
- Engineering or architectural services performed in the United States for production projects in the United States.

The qualification of the following activities for the deduction deserves special attention:

Construction Activities

Since the statute does not require that gross receipts from construction activities be derived from a lease, rental, license, sale, exchange or other disposition of the property, a taxpayer engaged in construction activities may qualify for the deduction even if the taxpayer does not possess the benefits and burdens of ownership of the property being constructed. Therefore, more than one taxpayer may be regarded as constructing real property and qualify for the deduction with respect to the same activity and the same construction project. The Fact Sheet provides as an example where a general contractor and a subcontractor may both be engaged in construction activities with respect to the installation of a roof on a new building. Each taxpayer's

benefit will be a percentage of its profit on its work with respect to the installation of the roof.

Gross receipts derived from the rental of real property constructed by the taxpayer are not considered as derived from construction, but rather are treated as income for the use or forbearance of the property. As a result, rental income from real property (unlike rental income from qualifying tangible personal property) is not eligible for the qualified production activities deduction. Gain on the later sale of the property may qualify for the deduction if all other requirements are satisfied.

Preparation of Food or Beverage Activities

The IRS guidance confirms that food and beverages prepared at a retail establishment do not qualify for the deduction. A retail establishment is defined as tangible property (both real and personal) used in the trade or business of selling food or beverages to the public if retail sales occur at the facility. However, food and beverages prepared for wholesale distribution would be eligible production activity income. If an establishment has both retail and wholesale activities, the activities will need to be separated. A portion of retail food sales may qualify for the deduction if the establishment produces the sale item (e.g., a bakery that bakes its own bread or a coffee shop that roasts coffee beans used in brewing coffee for retail sale).

Computer Software Activities

In general, income from a lease, rental, license, sale, exchange or other disposition of software developed in the United States qualifies for the deduction, regardless of whether the customer purchases the software off the shelf or takes delivery of the software by downloading the software from the Internet. However, the IRS Fact Sheet specifically excludes the following income sources as qualified production activities income:

- Fees for online software use.
- Fees for customer support with respect to computer software.
- Online services.

- Fees for telephone services provided in part through the use of software.
- Fees for playing computer games online.
- Provider-controlled online access services.

Allocating Cost of Goods Sold and Other Deductions

To compute the domestic production activities deduction, the domestic production gross receipts are reduced by the associated cost of goods sold and by any allocable costs and deductions, to arrive at qualified production activities income.

Cost of Goods Sold

Under the IRS guidance, if a taxpayer cannot specifically identify the qualified cost of goods sold they may use any reasonable method. However, if the taxpayer uses a method to determine the allocable portion of its gross receipts derived from qualified production activities, the taxpayer must use the same method for determining the allocable cost of goods sold.

Other Deductions

The IRS guidance provides three methods for allocating other deductions to qualified production activities.

The first method is available to all taxpayers and generally follows existing Treasury regulations applicable to taxpayers required to determine taxable income from within and outside the United States. Generally, this method will require taxpayers to: (1) allocate to an item of gross income all expenses directly related to that

item of gross income; and then (2) apportion other expenses among all items of gross income on a ratable basis (typically based on a ratio of gross receipts). Several specific expenses have their allocation and apportionment methods expressly defined in the Treasury regulations.

The second method is available to taxpayers with average annual gross receipts (over the three prior years) of \$100 million or less, or total assets at the end of the taxable year of \$10 million or less. It provides a simplified formula that allocates deductions based on the ratio of the taxpayer's receipts derived from qualified production activities as compared to the taxpayer's receipts from all sources.

The third method is available to taxpayers with average annual gross receipts of \$5,000,000 or less and certain other small taxpayers permitted to use the cash method of accounting. This method allows these taxpayers to utilize the same methodology as the second method for determining their other deductions and also allows them to employ the same methodology for cost of goods sold.

Partnerships and S Corporations

For pass-through entities (partnerships and S corporations) the IRS guidance confirms that the deduction attributable to the qualified production activities of the pass-through entity is determined at the partner or shareholder level. As such, each partner or shareholder must compute the deduction separately based upon infor-

mation provided by the pass-through entity.

Affiliated Groups

An "expanded affiliated group" is treated as a single corporation for purposes of applying IRC Sec. 199. An "expanded affiliated group" consists of members of an affiliated group eligible to file a consolidated tax return, except that for purposes of Sec. 199, 50 percent stock ownership is substituted for 80 percent stock ownership and certain excluded corporations are included. The IRS Regulations provide additional guidance with respect to the application of Sec. 199 to expanded affiliated groups.

State and Local Tax Effect

As with other federal tax legislation providing federal economic incentives, we will closely monitor which states allow the domestic production activities income deduction for state and local tax purposes.

BDO Seidman, LLP Section 199 Workbook

Please see our Section 199 Workbook for more detailed information to assist in determining qualification for and computation of the Section 199 domestic production activities deduction at the following link: <http://www.bdo.com/about/publications/tax/Section199Workbook.pdf>.