Domestic Production Activities Deduction

Chapter 7   pp. 213 - 243

2016 National Income Tax Workbook™

Terminology
Computing the Deduction
Limitation on the Deduction Amount
Reporting the Deduction on F8903
Pass-Through Entities
Agricultural & Horticultural Cooperatives
Specific Industries
Domestic Production Activities Deduction  p. 214

- Tax years after 12/31/2004
- Increasing rate – top at 9% since 2010
- DPAD = smallest of
  1. 9% taxable income from QPAI
  2. 9% taxable income without DPAD
  3. 50% of W-2 wages attributable to DPGR
- Allowed for both regular and AMT tax

Qualified Production Activities Income  pp. 214-215

QPAI = Domestic Production Gross Receipts (DPGR) less:
1. Items directly allocable to DPGR
   - Cost of goods sold
   - Deductions, expenses, losses
2. Ratable portion of items not directly allocable to any class of income
Domestic Production Gross Receipts  p. 215

DPGR = gross receipts from lease, rental, license, sale, exchange, other disposition of

1. Qualifying production property (QPP) manufactured, produced, grown or extracted (MPGE) by TP, in whole or significant part, in the U.S.
2. Film production in certain circumstances
3. Electricity, natural gas, or potable water produced by the TP in the U.S.

Domestic Production Gross Receipts  p. 215

- Includes receipts from:
  1. Construction or substantial renovation of real property in U.S.
  2. Services performed in U.S. relating to construction of real property
  3. Self-constructed property used by taxpayer
  4. Business interruption insurance proceeds & payments not to produce
Embedded Services:

- Generally, services do not qualify as DPGR
- If services part of regular product price & not sold without product, some services in DPGR
  - Certain warranties
  - Deliveries
  - Instruction manuals
  - Installation
  - Computer software maintenance agreements

De minimis exceptions

- If embedded services < 5% of gross receipts, can include in DPGR
  - N/A if service amount separately stated
- If non-DPGR receipts < 5% of total gross receipts, can include in DPGR
Qualified Production Property  

Tangible personal property (TPP)
- Other than land; buildings; qualified film produced by the taxpayer; electricity, natural gas, or potable water produced by the taxpayer
- Computer software
- Sound recordings

Manufactured, Produced, Grown, Extracted  

1. Manufacturing, producing, growing, extracting, installing, developing, improving, creating QPP
2. Making QPP from scrap or new materials or by combining 2 or more articles
3. Cultivating soil, raising livestock, fishing, mining
4. Installing QPP is in another activity with the QPP
5. Storage, handling or other processing activities connected with certain agricultural products
MPGE

pp. 216-217

Does not include:

- Transportation
- Packaging, repackaging, labeling, or minor assembly of QPP
- QPP installation if no other MPGE for the QPP

IRS Guidance on MPGE

p. 217

LB&I guidance on retail activities not deemed MPGE:

- Cutting blank keys to customer specs
- Mixing base paint & paint coloring agent
- Applying cake decoration if not baked where sold
- Applying gas to AG products to affect ripening
- Storing AG products to extend shelf life
- Maintaining plants and seedlings
Installation Activities

pp. 217-218

- Installation qualifies as MPGE if:
  1. TP manufactured, produced, grew, or extracted the QPP; and
  2. During installation, TP had benefits & burdens of QPP ownership or is treated as meeting ownership rules of government contracts

- Prop Regs – If QPP MPGE, install is MPGE

MPGE by the Taxpayer

pp. 218-219

- Business with ownership benefits & burdens during MPGE activity gets DPAD
- Government contracts treated as TP’s activity even if title transferred prior to completion
- In whole or significant part w/in U.S. = 50 states, D.C., U.S. territorial waters and seabeds and subsoils where U.S. has exclusive exploration/exploitation rights
  - Puerto Rico if U.S. taxed & before 1/1/2017
Substantial in Nature Test

Factors to consider:

- Relative value added
- Relative cost
- Nature of the activity
- Nature of the property

Safe Harbor Test

Treated as having MPGE “in whole or significant part…”

1. TP’s direct labor & overhead costs for MPGE of QPP in U.S. ≥ 20% of QPP’s COGS
   OR
2. No COGS, TP’s direct labor & overhead total ≥ 20% of QPP unadjusted depreciable basis
Computing the Deduction

DPAD = 9% x lesser of QPAI or taxable income

QPAI = DPGR less
- COGS, expenses losses allocable to DPGR

COGS include:
- Costs allocated to inventory under § 263A
- Costs allocated to inventory under general inventory valuation rules – includes LIFO
- Basis of noninventory if sales in DPGR

Computing QPAI – COGS

If TP has DPGR & non-DPGR, must allocate
- Reasonable method consistently applied

Small Business Simplified Overall Method
- Average annual gross rec ≤ $5M for prior 3 yrs
- Farmer not required to use accrual
- Average annual gross rec ≤ 10M & cash o.k.

DPGR allocation = COGS x \[
\frac{DPGR}{\text{Total G. R.}}\]
Computing QPAI – Other Costs
pp. 221-222

- Other deductions/costs allocable to DPGR
  - I.R.C. § 861 method
    - More accurate but complex - costs may exceed benefit of using
  - Small business simplified method (SBSD) or
    - Allocated based on DPGR/Total GR
  - Simplified deduction method
    - Allocated based on DPGR/Total GR

Computing QPAI – Other Costs
pp. 221-222

- Must use chosen method for all deductions
- May switch methods year by year
- May use statistical sampling for allocations
Computing QPAI - Other Losses pp. 222-223

- Loss allocable to DPGR if property is QPP
- Net Operating Losses:
  - Not included in QPAI computation
  - Part of DPAD taxable income limitation
  - DPAD cannot create or increase NOL carryover / carryback

Rules for Expanded Affiliated Group pp. 223-224

- Expanded Affiliated Group (EAG) = 1 corp
  - Apply § 1504 using > 50% in lieu of ≥ 80%
  - Aggregate all taxable income/loss, QPAI and W-2 wages, remove GR from related entities
  - Membership in EAG determined daily
    - Member part year, has two DPAD amounts
Limitation on Deduction Amount
pp. 224-225

Wage Limit

- DPAD may not > 50% W-2 wages properly allocable to qualifying production activity

- Wages from flow-through with a qualifying production activity flow to owner – may make Schedule C or F DPAD allowable

Limitation on Deduction Amount
p. 225

Taxable Income Limit

- Deduction limited to 9% of the lesser of:
  - Qualified Production Activities Income (QPAI) or
  - Entity taxable income without the DPAD

- Individuals: limitation = AGI after applying §§ 86, 135, 137, 219, 221, 222, 469

- AMT: Allowable for AMTI but not in ATNOL
Reporting DPAD on Form 8903 pp. 226-227

- Joint return – combine items for Form 8903
- Need positive amounts for:
  - QPAI
  - AGI for an individual, estate, or trust
  - Form W-2 wages paid to employees
Pass-Through Entities  
pp. 228-229

- DPAD computed at SH level
  - If basis, at-risk or passive limitations apply use proportionate share of each DPAD item
  - In year items allowed, use to compute QPAI
  - DPAD does not reduce basis in PS or S corp

QPAI Determined at Entity Level  
p. 229

- Some S corps or PSs may determine QPAI
  - Allocate QPAI and W-2 wages to K-1s
  - SH/PN cannot recalculate using another cost allocation method
- Entities eligible to compute QPAI
  - § 861 partnership
  - Widely held pass-through entity
  - Small pass-through entity
§ 861 partnership

- ≥ 100 Partners
- ≥ 70% Qualifying Partners
- Qualifying Partner:
  - Not manager
  - No material participation
  - < 5% interest

Eligible widely held pass-through entity

- Average GR ≤ $100M in 3 preceding and total assets ≤ $10M end of current
- Has DPGR, COGS & deductions ≤ $10M
- Only has: individuals, estates, QSST
- No one owns > 10% (prof/cap int., shares)
QPAI Determined at Entity Level p. 229

**Eligible small pass-through entity**

- PS or S corp qualified for small business simplified overall method
- Has DPGR
- Has total costs of ≤ $5,000,000
- If PS, does not have ineligible PN or an EAG PS as a PN

W-2 Wages & QPAI at Entity Level p. 230

- Rev. Proc 2007-34 provides rules:
  1. Account for separately & nonseparately stated items
  2. Include income items the inclusion of which is normally determined at PN/SH level
  3. Subtract expense items which the expense or capitalization is determined at PN/SH level
  4. Disregard any limitation on deductions applied at PN/SH level
5. Account for expenditures for certain tax preferences w/optional write-off without regard to any PN/SH election

6. Disregard any expenditure that the PN/SH could elect as deduction or credit

7. Compute and account for any depletion under § 613A, without regard to any PN/SH level limitations

8. Take into account increase/decrease in basis of PS assets under § 743(b)

9. Exclude any entity items allocated by an eligible § 861 PS to a PN that is not a qualifying PN

10. QPAI will be < zero if entity’s DPGR is not > entity’s items deducted for QPAI
Entity Level – Cost Allocations  
[p. 230]
- Eligible § 861 PS must use § 861 method
- Eligible widely-held pass-through entity must use simplified deduction method
- Eligible small pass-through entity must use the small business method

Entity Safe Harbor  
W-2 Wages  
[p. 231]
- Small Business Method Safe Harbor
  - PS or S corp using small business method
  - % wages allocable to DPGR = DPGR/Total GR
- Wage Expense Safe Harbor
  - PS or S corp using § 861 method or simplified deduction method
  - % wages allocable to DPGR = wages in QPAI/all wages for the year
Allocating QPAI & Wages

- QPAI allocation:
  - Partnership: in same proportion as gross income or in proportion to profits interests
  - S corp: in proportion to shareholder ownership
- W-2 wage allocation:
  - In same manner as allocated to PNs & SHs

Reporting the Deduction

Partnership:

Fig 7.7 Schedule K-1 Line 13 Codes

<table>
<thead>
<tr>
<th>Schedule K-1 Line 13 Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code T. Domestic production activities Information</td>
<td>Provides the partner with a statement that includes information used to figure the DPAD</td>
</tr>
<tr>
<td>Code U. Qualified production activities income (QPAI)</td>
<td>Provides the partnership’s allocation of QPAI to the partner that the partner reports in the applicable line 7 column of Form 8903</td>
</tr>
<tr>
<td>Code V. Employer’s Form W-2 wages</td>
<td>Provides the partnership’s allocation of Form W-2 wages to the partner that the partner reports on line 17 of Form 8903</td>
</tr>
</tbody>
</table>
### S Corporations:

**Fig 7.8 Schedule K-1 Line 12 Codes**

<table>
<thead>
<tr>
<th>Schedule K-1 Line 12 Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code P. Domestic production activities information</td>
<td>Provides the shareholder with a statement that includes information used to figure the DPAD</td>
</tr>
<tr>
<td>Code Q. Qualified production activities income (QPAI)</td>
<td>Provides the S corporation's allocation of QPAI to the shareholder that the shareholder reports in the applicable line 7 column of Form 8903</td>
</tr>
<tr>
<td>Code R. Employer's Form W-2 wages</td>
<td>Provides the S corporation's allocation of Form W-2 wages to the shareholder that the shareholder reports on line 17 of Form 8903</td>
</tr>
</tbody>
</table>

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### Specific Industries

**pp. 233 - 243**

DPAD can apply to:

- Agricultural & Horticultural cooperatives
- Computer Software
- Farmers
- Construction
- Architects and Engineers
- Food and Beverage Producers
- Electricity, Natural Gas & Potable water
- Oil and gas industry
THANK YOU