Abstract: A special tax deduction for "domestic production activities" is available to traditional manufacturers, as well as to eligible construction contractors, engineers, architects, software developers, film producers, energy producers, farmers and agricultural processors. After a five-year phase-in period, the manufacturers' deduction (also commonly referred to as the Section 199 or domestic production activities deduction) reaches its maximum level in 2010. This article provides an overview of the deduction.

The production deduction

After a series of adverse rulings by the World Trade Organization (WTO), Congress curtailed its efforts to benefit exporters and instead provided a tax deduction for all manufacturers — whether they export or not.

The American Jobs Creation Act of 2004 (AJCA) repealed the extraterritorial income (ETI) exclusion and established the manufacturers' deduction — also commonly referred to as the Section 199 or domestic production activities deduction. And the deduction isn't just for traditional manufacturers. It's also available to eligible construction contractors, engineers, architects, software developers, film producers, energy producers, farmers and agricultural processors. After a five-year phase-in period, the deduction reaches its maximum amount in 2010.

How the deduction works

The manufacturers' deduction permits eligible taxpayers to deduct a specified percentage of the lesser of: 1) their income from "qualified production activities," or 2) their taxable income for the year. The deduction may not exceed 50% of the W-2 wages a taxpayer pays during the year. Wages not allocable to domestic production gross receipts are excluded from W-2 wages for the purposes of the deduction.

The specified percentage phased in from 2005 through 2009 and reaches its maximum amount in 2010, going up from 6% in 2009 to 9% in 2010 and thereafter. As a result, in 2010 the deduction will lower the maximum effective marginal tax rate on qualifying income from 35% to 31.85%.

Qualified income is calculated by taking gross receipts from domestic production and subtracting the cost of goods sold and other allocable costs, deductions, expenses and losses. Domestic production gross receipts are those derived from any lease, rental, license, sale, exchange or other disposition of:

- Qualifying production property (including tangible personal property, computer software and certain sound recordings) manufactured, produced, grown or extracted by the taxpayer in whole or in significant part in the United States,

- Qualified films produced by the taxpayer, or

- Electricity, natural gas or potable water produced by the taxpayer in the United States.

Domestic production gross receipts also include receipts from construction and engineering or architectural services performed in the United States.

Two significant exceptions are receipts from the sale of food and beverages prepared by taxpayers at retail establishments and the transmission or distribution of electricity, natural gas and potable water.

Additionally, the deduction isn't allowed in determining net earnings from self-employment and generally can't reduce net income below zero. But it can be used against the alternative minimum tax (AMT).

Looking more closely

The manufacturers' deduction provides many companies with a potentially significant tax break. But the rules are complex, so be sure to take a closer look at whether you might qualify and what you need to do to maximize your tax savings.

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