Training notes from the woods & the classroom

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Domestic Production Activities Deduction

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Though the name sounds boring, this commonly overlooked deduction can provide you with a significant tax benefit.

What is it?

A tax provision that attempts to remove the competitive disadvantages that US companies have in relation to companies located in other taxing jurisdictions.

How Much Will It Save Me?

It depends upon your tax bracket but you are allowed to deduct 6% (2007 through 2009) of your "qualified production activities income" limited to your net income or 50% of W-2 wages paid by your business, whichever is lower. In 2005 and 2006 the deduction amount was 3% and in 2010 and thereafter it is supposed to increase to 9%.

Do I Qualify?

First of all, your business must pay W-2 wages. If you don't pay wages you do not qualify. Payments made to independent contractors and reported on a Form 1099 are not wages.

Assuming you make it past that first hurdle, then you need to have "Domestic Production Gross Receipts". Income from the sale of forest products, as long as they are produced in the United States, qualify. Note the following examples:

Example 1: John Beam owns a logging business that purchases stumpage from the government and from private landowners. He cuts the stumpage and sells the logs and pulp to a variety of mills. The receipts from the sale of cut timber are domestic production gross receipts.

Example 2: John Beam owns a logging business that cuts under contract for ABC mill. The mill provides the stumpage and requires the cut timber to be delivered to their mill. In essence, Mr. Beam is providing a harvesting service. Receipts in this scenario are **not** domestic production gross receipts.

Example 3: Same as example 1 except that Mr. Beam utilizes Section 631(a) (the election to treat cutting as a sale) in order to shift some of his income from ordinary to capital gain income. The portion of receipts taxed as long term capital gains will **not** qualify as domestic production gross receipts. The ordinary income portion **will** qualify as domestic production gross receipts.

How is the Deduction Calculated?

Once you have determined the domestic production gross receipts you need to reduce it by expenses, deductions, cost of goods sold, etc., that are allocable to those receipts. For small businesses this can be as simple as allocating those expenses by the same ratio that domestic production gross receipts have to total receipts, i.e., if 70% of gross receipts qualify as domestic production gross receipts then those receipts would be reduced by 70% of total expenses. This process will generate "qualified production activities income". This is the number you multiply by the applicable percentage to get the actual deduction.

Limitations:

Taxable Income – the applicable percentage will be multiplied by taxable income if it is less than qualified production activities income. If taxable income is less than zero there will be no deduction.

W-2 Wages – the allowable deduction is limited to 50% of W-2 wages paid. For tax years beginning before May 18 2006, all wages may be used in determining this limitation. After May 17, 2006 only those wages paid that are allocable to domestic production gross receipts can be used for purposes of determining this limitation.

Where Do I Take the Deduction?

If you are a sole proprietor or single member LLC being taxed as a sole proprietor – the deduction will be taken in the "adjustments to income" section of your tax return (the lower portion of the front page of your Form 1040).

If you are a member of a partnership or a shareholder in an S Corporation – the needed information will be reported on the appropriate business schedule and then pass through from the business (on Schedule K-1) to the individual partner or shareholder returns.

If you are a shareholder of a C Corporation the deduction will be reported directly on the tax return for the Corporation, Form 1120.

About the Author

Geary Searfoss is a Certified Public Accountant as well as an Enrolled Agent and a Certified Forester. He offers a unique combination of forestry and tax preparation qualifications and experience.

Training

The Domestic Production Activities Deduction was one of the topics addressed during MLEP's "Federal Taxation Issues for Loggers" workshops which were held June 12 in Bemidji and June 14 in Duluth. Copies of the materials from the workshops are available by request from the MLEP office.

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