

**Abstract:** The domestic production activities deduction provides a tax break for certain “domestic production activities.” Unfortunately, many businesses tend to overlook it because they believe the tax break applies only to a few industries. This article points out that the deduction remains available to a wide range of businesses for the 2017 tax year and delves into some industry-specific details. A sidebar discusses IRS guidance on the W-2 wage limitation to taxpayers with a short taxable year as it applies to the domestic production activities deduction.

## **Take a look at the domestic production activities deduction**

The domestic production activities deduction (DPAD) provides a tax break for certain “domestic production activities.” Unfortunately, many businesses tend to overlook this valuable tax break because they believe it’s applicable only to certain industries. In fact, the deduction remains available to a wide range of businesses for the 2017 tax year.

### **Significant benefits**

Calculating the DPAD is complex. Generally, the deduction is equal to the lesser of 9% (6% for “oil-related” activities) of a company’s income from qualified production activities or its taxable income. In addition, the deduction can’t exceed 50% of W-2 wages for the year that are attributable to domestic production.

To determine its qualified income, a business needs to start with its gross receipts from qualified domestic production activities and subtract the cost of goods sold and certain other costs allocable to those activities.

### **Industry specifics**

Over the last couple of years, the IRS has issued guidance related to the application of the DPAD to several specific industries. These include:

***Contract manufacturing.*** Which party to a contract manufacturing arrangement is entitled to claim the DPAD? Under current rules, the answer depends on which party enjoys the benefits and bears the burdens of ownership. That, in turn, depends on several factors, including which party:

- Retains legal title to manufactured property during production,
- Controls the property and the process,
- Bears the risk of loss or damage,
- Receives profits from the property’s sale, and
- Pays property taxes.

To eliminate the uncertainty associated with this analysis, proposed regulations would establish a bright-line test under which the party that actually performs the activity would be entitled to claim the deduction.

**Construction.** Qualified production activities include those associated with the construction or substantial renovation of U.S. real property, including those “typically performed by a general contractor,” such as management and oversight of the construction process. Proposed regulations would clarify that a contractor whose activities are limited to approving and authorizing invoices and payments is ineligible for the DPAD.

**Testing and packaging.** Under current rules, qualified production activities may include testing of component parts, packaging, repackaging, labeling and “minor assembly.” Proposed regulations would exclude these activities if the taxpayer isn’t otherwise involved in manufacturing, producing, growing or extracting the property in question.

### **Assistance available**

If your business has claimed the DPAD before, or if you think you may be able to for the 2017 tax year, please contact us. We can assist you with both the calculations involved and compliance with IRS rules.

### **Sidebar: Treatment of W-2 wages under DPAD**

The IRS has provided guidance on the W-2 wage limitation to taxpayers with a short taxable year as it applies to the domestic production activities deduction. Wages are calculated on a calendar-year basis, and there had been some uncertainty over the treatment of wages paid during a short tax year that didn’t include a calendar year end. Temporary regulations provide that wages paid to employees during such a short tax year are included for the purposes of the W-2 wage limitation.

The temporary regulations also clarify the treatment of wages when a business is acquired or disposed of during the year. If employees receive wages from two different taxpayers, those wages are allocated between the taxpayers based on the employees’ respective periods of employment with each taxpayer.