Don't Leave Money on the Manufacturing Floor

Make Sure You Take Advantage of the Domestic Production Tax Benefits

After an examination of our new manufacturing client's financial statements and tax returns, we found an opportunity for the client to claim a 9% tax deduction they previously were missing out on.

There are significant tax benefits available to manufacturers that have manufacturing bases in the United States, as long as at least 20 percent of the total costs are the result of direct U.S. labor and overhead costs. This "safe harbor" rule (IRS Proposed Regulations 1.199-3(f)(3)), allows manufacturing businesses with "qualified production activities" to take a tax deduction of currently 9% from net income.

"We recently were able to assist a new client to be able to take advantage of a significant tax benefit. This manufacturer produces specialty food products and its prior accountant had not been claiming the IRC Section 199 Domestic Production Activities Deduction," says Paul Simons, Tax Principal at DS&B.

U.S. Manufacturing businesses' qualified production activities will need to implement cost accounting mechanisms to make sure their tax deduction is accurately calculated, but the prior year adjustments can work in favor of the business as well. Although mostly straight-forward, there were some areas where our client's previous accountant missed the exception.

"Recent years increased profitability made claiming the 9% deduction quite valuable. We worked with the new client to best position for claiming the Section 199 deduction including consulting with respect to an accounting method change to help support the claimed deduction going forward. The accounting method change application should help prevent any prior year adjustments by the taxing authorities as well." – Paul Simons.

While there can be complicated circumstances with any business depending on how they operate according to the rules of Section 199, every manufacturing business or small business should check to see if they qualify. There's a good chance they will.

QUICK FACTS —INTERNAL REVENUE CODE SECTION 199:

Domestic Production Activities Deduction

A business engaged in a qualifying production activity is eligible to take a tax deduction of 3% in tax years 2005 and 2006. The deduction increases to 6% in year 2007, and 9% in years 2010 and later.

Qualified Production Activities

- Manufacturing "qualified production activities" eligible for claiming the deduction under Internal Revenue Code Section 199:
- Manufacturing based in the United States,
- Selling, leasing, or licensing items that have been manufactured in the United States,
- Selling, leasing, or licensing motion pictures that have been produced in the United States,
- Construction services in the United States, including building and renovation of residential and commercial properties,
- Engineering and architectural services relating to a US-based construction project,
- Software development in the United States, including the development of video games.

General Rule and Safe Harbor

If any part of manufacturing or production activities is outside the United States, then businesses must use either the safe harbor rule (at least 20% of total costs are from US-based production activities) or allocate costs using the facts and circumstances of their business.

Production Activities Not Qualified Under Section 199

Excluded from claiming the Domestic Production Activities Deduction:

- Construction services that are cosmetic in nature, such as painting.
- Leasing or licensing items to a related party.
- Selling food or beverages prepared at a retail establishment.

To learn more, contact:

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