**Tax Tips**

**The Code Section 199 Domestic Production Activities Deduction (Part 1 of 2)**

Code Section 199—enacted to help offset the repeal of a tax break for U.S. exporters—provides a deduction for many U.S. businesses that's allowed for both regular tax and alternative minimum tax (AMT) purposes. The deduction doesn't have an official name. It's been called, among other things, “the U.S. production activities deduction,” the “domestic production activities deduction” (DPAD), and the “domestic manufacturing deduction” (DMD). For simplicity's sake, we're calling it the Code Section 199 deduction.

The Code Section 199 deduction is allowed to all taxpayers—individuals, C corporations, farming cooperatives, estates, trusts, and their beneficiaries. The deduction is allowed to partners and the owners of S corporations (not to partnerships or the S corporations themselves), and may be passed through by farming cooperatives to their patrons. And, despite the deduction's history, it's fully available to taxpayers who don't export.

The Code Section 199 deduction equals 9% of the net income from eligible activities. However, the amount of the deduction for any tax year may not exceed the taxpayer's taxable income or, in the case of individuals, the taxpayer's adjusted gross income. The deduction is designed to be economically equivalent to a 3% reduction in the tax rate on eligible activities conducted in the U.S. This means that if the tax rate on the business income from an eligible activity would normally be, say, 36%, the Code Section 199 deduction reduces it to 33%.

In addition, the amount of the Code Section 199 deduction can't exceed 50% of the “W-2 wages” (wages subject to income tax withholding, and certain deferred compensation) paid to employees for the year that are allocable to the activities eligible for the deduction. This means that businesses operated as sole proprietorships or partnerships with no employees aren't eligible for the deduction. (To take advantage of the deduction, such businesses can incorporate and pay W-2 wages to their principals.)

As noted above, the Code Section 199 deduction equals a percentage of the net income from eligible activities. Among the more common eligible activities are: the manufacture, production, or growth of tangible personal property, in whole or in significant part within the U.S.; the construction of real property in the U.S.; and the performance of engineering or architectural services in the U.S. in connection with real property construction projects in the U.S.

Purely sales activities aren't eligible for the deduction, nor are purely service activities, except for construction, engineering, and architectural services.

There’s lot more to discuss concerning the Code Section 199 deduction. In next month’s Tax Tips, I’ll address those other matters.

In the meantime, if you have any questions regarding the Code Section 199 deduction, or any other tax matter, please feel free to give me a call at (562) 698-9891.

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