



Freed Maxick & Battaglia, PC
Certified Public Accountants

Domestic Manufacturers' Deduction

A guide to finding new
opportunities others might miss.



The Domestic Manufacturers' Deduction.

The American Jobs Creation Act of 2004 established a deduction for domestic production activities, commonly known as the domestic manufacturers' deduction. With it, the definition of "production" was broadened to include areas not traditionally referred to as manufacturing.

If you're a traditional manufacturer, this means you should qualify for more deductions under the new rules.

If you're a software development, architecture, engineering or construction business, it means you're now included in a group of taxpayers who can qualify for this deduction.

The tax savings for your business could be significant. Once the law is fully phased in (from 2005 through 2010), you could lower your effective tax rate up to three percentage points.

You've taken the first step in finding your new tax savings by contacting Freed Maxick. As an international tax and business consulting firm focusing on the unique needs of mid-sized companies, Freed Maxick is on the leading edge of interpreting this complex tax law. We designed this guide to help clarify the broad scope of the deduction and give you a sample of some of the situations that might enable you to enhance your deductions.



How do you think your business might qualify for this deduction? Contact us to discuss your unique situation. We'll leverage our strong industry experience and create a customized approach to help you identify and substantiate qualifying activity so you can achieve the full benefit intended for companies like yours.

Calculating the domestic manufacturing deduction can be a complex process. Our tax professionals will guide you through critical steps.

Identifying qualified activities

New IRS rules define production to include areas not traditionally considered manufacturing. Activities that may qualify for the deduction include:

- Manufacture, production, growth or extraction
- Software development
- Music recording and film production
- Production of electricity, natural gas or water
- Construction or substantial renovation
- Engineering and architecture services

Nonqualified activities may include embedded services such as warranties and retail sales.

Determining where property is produced

To qualify for the deduction, property must also be produced "in whole or significant part within the United States." The IRS has outlined a facts and circumstances test to help companies assess their qualification.

You can also use a safe harbor test to determine whether you meet this standard. This involves mathematical computation to determine whether conversion costs to produce property account for 20 percent or more of the total property. If this is the case, and conversion activities take place in the United States, the activity may qualify for the deduction.

Applying special rules and exceptions

A number of special rules and exceptions must be analyzed to ensure the deduction is properly claimed. These rules and exceptions can be favorable to the taxpayer. For example, if less than 5 percent of your activities are nonqualified, all of your activities may still qualify.

Properly allocating costs

Only net income derived from U.S. production activity qualifies for the domestic manufacturers' deduction. Therefore, as costs are allocated to qualified production receipts, the tax benefit is reduced.

To receive the full deduction to which you're entitled, you must properly allocate expenses, ensuring costs associated with foreign and other nonqualified activities are allocated only to nonqualified gross receipts.

If you are a taxpayer with average revenues of less than \$25 million, you may be able to use a simplified allocation method.

Calculating income and expenses

IRS rules require taxpayers to compute qualified production activity income on an item-by-item basis. Many accounting systems are not designed to calculate income and expenses in this manner. Therefore, it may be difficult to determine your deduction using a traditional accounting system.

An experienced tax professional can help you determine which of your business activities qualify for the domestic manufacturers' deduction. The tax advisor can also help you ensure that the deduction is properly calculated and supported.

You might miss qualified business activities unless you trust experienced and well-trained professionals to advise you. **Take the next step and speak with a Freed Maxick & Battaglia, CPAs advisor. Call 716.847.2651 or visit www.freedmaxick.com.**

By inquiring about the domestic manufacturers' deduction today, you pave the way to further reducing taxable income in upcoming years.

Does your business process, manipulate, refine, install, develop, create, combine or assemble items in the United States? These are some of the terms the Internal Revenue Service uses to illustrate the broad scope of activities that qualify for the deduction.

Which party to your contract manufacturing arrangements retains the benefits and burdens of ownership during the manufacturing process? Both parties cannot qualify for the deduction, so you want to plan properly to ensure you do.

Did you know business interruption insurance proceeds qualify? The rules contain special provisions like this for unique situations.

Is the warranty you provide included in the price of your products? Would it make business sense to revise your warranty program to qualify? Certain warranty service revenue is eligible for the deduction.

Can your system specifically identify the revenue from each item that qualifies? If not, you may need to develop a reasonable allocation method based on factors provided by the IRS. A safe harbor rule may apply.

Have you established how you will allocate costs of goods sold, direct costs and other indirect costs? The IRS requires this be done on an item-by-item basis and has outlined rules for each of these types of costs. Note: costs allocated to non-qualifying income will increase your deduction.


Do you apply the uniform capitalization rules to your production activity? If not, you need to consider consistency requirements.

Does your business qualify for any of the simplified methods, safe harbors or de minimis exceptions? For example, a de minimis amount of gross receipts from embedded services may qualify.

Are you aware qualified construction activities could include clean up, hauling, painting or landscaping? If you perform these services as a part of your construction projects, this revenue may qualify for the deduction.

Did you know engineering or architecture services for construction projects not completed might still qualify? This is another example of special provisions for unique situations that could increase your deduction.

Do you install, implement or service the products (including software) you sell? While the rules generally consider service revenue non-qualifying, certain services qualify for the deduction.

A black and white photograph of two men in a professional setting, possibly an office or a meeting room. They are both looking down at a large document or set of papers that one of them is holding. The man on the right is pointing at something on the document. The background is slightly blurred, showing what appears to be a modern office environment with large windows and a clean, minimalist design. The lighting is soft and even, highlighting the men's faces and the document they are reviewing.

The new definition
of “production”
opens your door to
new tax savings.