Domestic Production Activities Deduction (§199)

In the American Jobs Creation Act of 2004, Congress created a new deduction to encourage hiring and gradually replace the extraterritorial income exclusion, which had been found to violate World Trade Organization Agreements. This new Domestic Production Activities Deduction (DPAD) applies to farmers because they produce or grow qualifying property. Raising livestock, cultivating soil, and storing or handling agricultural products are qualifying activities. Form 8903 helps calculate the value of the deduction, also referred to as a section 199 deduction (§199). There are some terms that need explanation.

Domestic Production Gross Receipts (DPGR) for most cash-basis farmers are the gross receipts from products raised. This should include the cost of purchased animals that are sold, if they were bought for growing and resale. Sales of animals bought for draft, breeding or dairy purposes will not qualify, unless they were purchased when young and a large part of their value came from raising the animal on the farm. Sales of raised animals from the Form 4797 should be included because they were produced by the farmer. Sales of other property used in the business like land, machinery and equipment are excluded because they weren't property produced by the farmer. Custom hire income is also excluded unless it is covered in the safe harbor rule. Government payments that replace sales proceeds from commodities are DPGR. This includes direct payments under the 2002 Farm Bill, marketing loan gains and countercyclical payments. Cost-sharing payments, stewardship, and incentive payments from conservation programs probably do not qualify as DPGR. The safe harbor rule says if non-DPGR receipts are less than 5% of total gross receipts, then treat it as part of DPGR. This may allow farmers to use the gross income on their Schedule F to determine much of DPGR.

Qualified Production Activities Income (QPAI) is DPGR reduced by three categories:

a. Cost of goods sold allocable to such receipts
b. Other deductions, expenses or losses directly allocable to such receipts
c. Portion of deductions, expenses or losses not directly allocable to such receipts or another class of income

If all of a farmer's receipts on Schedule F are DPGR or under the safe harbor limit of 5% for non-DPGR, then costs are generally the deductible expenses of the farm. If not, then taxpayers in the trade or business of farming and not required to use accrual accounting can use a simplified method based on the ratio of DPGR to total gross receipts. If 75% of gross receipts are DPGR, then deductions are allocated 75% to DPGR and 25% to non-DPGR.

The Domestic Production Activities Deduction is the smallest of three numbers:

a. 3% of QPAI
b. 3% of an individual's adjusted gross income or 3% of an entity's taxable income (both computed without this section 199 deduction)
c. 50% of Form W-2 wages paid by the taxpayer (farm employer)

For many farmers that have hired labor, the deduction will be 3% of the total of net Schedule F income plus the gain from the sale of raised animals from the Form 4797. Since this deduction

is taken on the front of the Form 1040 under adjustments to income, it will not reduce the amount subject to self-employment tax.

The 3% applies in 2006, increases to 6% in 2007 and then to 9% after 2009. For a farmer with no employees who pays no W-2 wages, then 50% of nothing is zero and there is no deduction. The simplest of three methods for calculating Form W-2 wages excludes wages which are not subject to Medicare withholding so that wages are the lesser of the total entries of either Box 1 or Box 5 on the W-2 Form. (Box 1 is taxable wages, while Box 5 is Medicare wages). Medicare wages are used because there is no upper limit on it like there is for social security wages ($94,200 in 2006). If children working for parents are not subject to social security withholding, then their W-2 wages will not count in this calculation. Commodity wages would not count either.

How significant is the production deduction? If QPAI is $100,000 then 3% is $3,000. If the wages and AGI don't further limit the deduction and a farmer is in the 25% federal tax bracket, it would reduce federal taxes by $750. When the deduction is 9%, then it would be $2,250 less in federal taxes. As always, changing the AGI will reduce state income taxes, and may increase state tax credits like farmland preservation or homestead property. Self-employment (SE) taxes are not affected since the deduction is on the front of the Form 1040 and comes after SE taxes are calculated.

For entities like S corporations, partnerships, estates or trusts where the income taxes come from items passed through the entity to the shareholders, partners or individuals, the section 199 deduction is calculated at the individual level. In this case QPAI is calculated from DPGR (receipts) and expenses passed through from the entity.

The Form W-2 wages limit for these entities is the lesser of:

a. The owner's allocable share of wages, or
b. Two times 3% of the entity's QPAI allocated to the owner.

This changes in 2007 so that the QPAI for the entity wage limit will no longer have to be calculated but wages will have to come from allocable DPGR for the 50% of wages limitation.

C corporations take the section 199 deduction at the corporate level because it pays income taxes rather than passing through receipts and expenses to others. A corporation that has low taxable income will have a small DPAD even though it pays considerable wages and land rent.

Cash rent to a landowner or an LLC set up to rent land to a farm operation is probably not eligible for the DPAD. This rental activity probably is not producing qualifying property and it may not have any W-2 wages. On the other side of the transaction the cash rent will, however, reduce the QPAI of the operating farm business because the rent paid is an allocable deduction.

This is an overview of this new deduction from a farm perspective. It is applicable to domestic businesses that manufacture, grow, produce or extract qualifying property. Consult IRS instructions and your tax advisor for specific situations because there may be alternate methods or categories of exclusions which apply to your situation.