

The “Domestic Production Tax Deduction” for Geothermal Projects

By Charles R. Goulding and Michael Wilshere

Geothermal (Geo) installers and designers may be eligible for substantial tax deductions if they incur expenses on projects involving real property. IRC §199 also known as the “Domestic Production Activity” tax deduction provides a deduction equal to 9% of taxable income in a given year for certain projects. Section 199(§199) was enacted as part of the “American Jobs Creation Act of 2004” in order to encourage domestic manufacturing including construction. Congress intended that §199 create jobs in the United States and otherwise strengthen the U.S. economy. The incentive, however, reaches farther than manufacturing or production activities. At the Congressional conferences, in creating the act, the legislature concluded that “construction activities performed in the United States” was one of the activities to be incentivized, and that “activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure” should be considered “construction activities.” Moreover, “structural improvements, should be considered “substantial renovation” and thus eligible for the deductionⁱ. These incentives were eventually codified into IRC §199ⁱⁱ.

The breadth of §199 is quite wide. The chart below demonstrates the allocation of the §199 tax expenditure among industries in past years. It is interesting to note that over one-third of the deduction is typically claimed by industries other than manufacturing -- including businesses in the information, mining, wholesale, as well as the construction sector. Additionally, as table two below demonstrates, construction companies benefit significantly more from the deduction than manufacturing companies, as a greater share of their income is typically eligible.

Table 1: Demonstrates which industries claim the “Domestic Production Activity” the most:

Industry	2005	2006	2007	2008	2009	2010
Manufacturing	66%	65%	65%	66%	62%	65%
Information	11%	11%	12%	12%	17%	12%
Mining	6.4%	6.7%	6.4%	7.0%	3.0%	5.9%
Wholesale Trade	5.1%	3.5%	4.6%	4.4%	4.2%	4.36%
Utilities	3.1%	3.9%	4.8%	3.3%	3.8%	3.78%
Construction	4.5%	5.2%	2.7%	2.6%	2.7%	3.54%
Prof, scientific, technical	.8%	1.3%	1.2%	1.5%	2.2%	1.4%
Retail Trade	.7%	1.0%	.8%	1.0%	1.4%	.98%
Finance and Insurance	1.1%	.6%	.3%	.3%	.6%	.58%

Source: IRS (2012), Census Bureau (2012).

Table 2: Demonstrates how the construction industry benefits significantly more than most industries from the “Domestic Production Activity” deduction. Sixty six % of income from the industry is typically eligible for the deduction, compared with only thirty eight % in the manufacturing industry.

Table 2 Extent to Which Different Industries Claim Domestic Production Deduction Against Corporate Income Tax					
Industry Grouping	Total Number of Returns	Total Taxable Income (\$ millions)	Amount of Deduction Claimed (\$ millions)	Share of Deduction Claimed	Estimate of Qualifying Income as a Share of Taxable Income
Manufacturing	259,859	383,494	8,930	62.8%	38.8%
Information	116,514	63,265	2,447	17.2%	64.5%
Mining	38,348	24,126	421	3.0%	29.1%
Construction	742,436	9,786	388	2.7%	66.1%
Utilities	6,072	16,760	541	3.8%	53.8%
Wholesale Trade	375,922	51,992	594	4.2%	19.0%
Prof. & Tech. Services	864,803	26,077	318	2.2%	20.3%
Retail Trade	596,710	76,589	194	1.4%	4.2%
Total			14,228		26.5%

*Figures are based on tax year 2009 data. The deduction was worth 6% of qualifying income in 2009. Had businesses been able to claim the full 9% in 2009, the amount of the deduction claimed would have been 50% higher.
Source: IRS Statistics of Income Data.

As you can see many industry taxpayers take the deduction other than manufacturers. This amounts to substantial tax savings across the board. The WSJ recently published a summary of the largest tax expenditures for all businesses and small businesses for the fiscal year 2013. The deduction for income attributable to domestic production was the fourth largest total tax expenditure, creating more tax incentives than both the deduction for employer sponsored health insurance premiums and the 179 expensing of depreciable assets combinedⁱⁱⁱ. For fiscal years 2013 through 2017, it is estimated to be the second largest tax expenditure only behind the deferral of active income of controlled foreign corporations^{iv}. Moreover, the tax deduction is beneficial for a range of different taxpayers including corporations, individuals, partnerships, trusts and estates.

The starting point in determining eligibility is whether or not the taxpayer has “Domestic Production Gross Receipts(DPGR)”. Section 199 defines this to include receipts generated from:

- (i) any lease, rental, license, sale, exchange, or other disposition of—
 - a. qualifying production property which was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States
 - b. any qualified film produced by the taxpayer, or
 - c. electricity, natural gas, or potable water produced by the taxpayer in the United States,
- (ii) in the case of a taxpayer engaged in the active conduct of construction trade or business, construction of real property performed in the United States by the taxpayer in the ordinary course of business, or

- (iii) in the case of a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, engineering or architectural services performed in the United States by the taxpayer in the ordinary course of such trade or business with respect to the construction of real property in the United States.

Roman numerals (ii) and (iii) are especially relevant for the geothermal industry. Particularly, section (ii) provides the mechanism by which installers may take the deduction. Presumably, expenses incurred in the construction of the geo systems would fall within the “construction” category. Activities constituting construction include activities performed in connection with a project to erect or “substantially renovate” real property. Painting and aesthetics are activities constituting construction only if these activities are performed in connection with other activities that constitute the erection or “substantial renovation” of real property^v.

Case Law provides further guidance on the meaning of “construction of real property” and “substantial renovation”. In Gibson & Associates Inc. v. CIR, 136 T.C. 195 (2011) the taxpayer/heavy engineering and construction company claimed substantial DPGR (domestic production gross receipts) under § 199. Specifically, the company worked on 136 construction projects, most of them involving rehabilitating bridge and road work. The government argued that many of the projects were unqualified because they did not meet the test for “substantial renovation”. Particularly, the government asserted that the renovations did not either:

1. materially increase the value of the real property,
2. substantially prolonged the useful life of the real property, or
3. adapt the real property to a different or new use.

The court however disagreed with the government’s assessment. In ruling for the taxpayer and allowing the deductions for the projects at the issue the court held that the renovations in each case met one of the three elements of the test, reasoning that:

“the functionality and dollar values of the real property underlying most of the casualty projects increased substantially on account of petitioner’s work.”

And for each of the other projects in which petitioners work did not increase the dollar value of the infrastructure the court reasoned that:

“Petitioner restored the integrity of the infrastructure through substantial structural rehabilitation that allowed the infrastructure to function as intended for many years thereafter,” Thus, “petitioner’s work substantially prolonged the useful life of the infrastructure.”

Like the construction projects in Gibson, Geothermal projects as well as other HVAC installations usually involve “substantial renovations” to real property. Accordingly, these projects should be generating deductions under § 199. The formula for computing the net tax benefit is demonstrated below:

	Total Domestic Production Gross Receipts(DPGR)	
*Less	(Cost of goods sold)	
*Less	(Other expenses)	
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	Qualified Production Activities Income(QPAI)	
*Multiplied by	X	9%
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*Equals	Net Tax Deduction	
*Multiplied by	X	Marginal Tax Rate
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*Equals	Net Tax Benefit	

**Note the net tax deduction may not exceed 50 percent of the W-2 wages of the taxpayer for the taxable year.*

Conclusion

For some Geothermal and HVAC installers practically all of their business activities will qualify as Total Domestic Production Gross Receipts(DPGR) since many of these businesses perform only “substantial renovation” activities to real property. You can see then how the deduction can be quite substantial. With this, GHSP as well HVAC installers, engineers and architects should consult with their local tax professionals to determine whether or not their business activities are eligible for the deduction.

About the Authors

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References

ⁱ Gibson & Associates, Inc. v. C.I.R., 136 T.C. 195 (2011)

ⁱⁱ 26 U.S.C.A. §199

ⁱⁱⁱ <http://online.wsj.com/public/resources/documents/SBASTudy1.pdf>

^{iv} <http://online.wsj.com/public/resources/documents/SBASTudy1.pdf>

^v Notice 2005–14, sec. 4.04(11)(a) and (b), 2005–1 C.B. at 520