

Qualified Domestic Production Deduction for Small Businesses

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The new Qualified Domestic Production Deduction (QDPD) allows businesses who make, produce, grow or extract the products it sells or businesses who construct or substantially renovate buildings an **extra deduction up to 3% of their taxable income** before the deduction. This deduction is scheduled to **double in 2007 to 6% and increase again in 2010 to 9%**. The application and computation for this deduction is very complex (feel read to read [IRS Notice 2005-14](#)) so please see your tax adviser if you believe you may be entitled to this deduction.

Due to the complexity of this calculations, the IRS has graciously announced safe harbors, *de minimus* rules and simplification methods, especially for cash basis taxpayers and taxpayers with average annual gross receipts of \$5,000,000 or less. The sad part is that even with the simplification methods many otherwise qualified small businesses won't be able to take advantage of this deduction due to the deduction's limitations. One of the limitations is 50% of the related W-2 wages. The other is to either taxable income or adjusted gross income.

Bob makes beautiful handcrafted solid wood furniture. He has no employees and is a **sole proprietor**, so even though he personally provides all the necessary labor to produce his product due to the wage limitation, he cannot take advantage of this new deduction.

Dean grows hay and other grains. He files a **schedule F** and has no employees. He does all the work on his farm, but he too will not be able to take advantage of this deduction due to lack of W-2 wages.

John and Mary have a small architectural firm and design custom homes. They chose to incorporate; therefore they each receive a W-2 salary from the **corporation**. However they have a corporate policy of giving bonuses based on their production, as incentive to generate more income for the corporation. This often results in the corporation showing little to no taxable income, which makes them unable to take advantage of this deduction.

Ray and James are construction engineers who design commercial buildings. They formed a **LLC taxed as a partnership**. They pay each other guaranteed wages, but no W-2 wages, so they are not able to take advantage of this deduction.

Donna and Jennifer create elegant beaded jewelry. They have organized as an S-corporation and take most of their income in the form of distributions. They do pay each other a modest W-2 salary and their deduction will be limited to half of these wages up to 18% of their income from this activity.

This makes me wonder if the objectives of the IRS aren't to make:

- more sole proprietors, farmers and partnership consider incorporating,
- more S-corporations consider paying larger salaries, and
- more corporations consider giving less bonuses, such that the corporation will show a taxable income
- all entity types consider eliminating their contract labor workers and pay everyone a W-2 wage.

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