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### **DOMESTIC PRODUCTION ACTIVITIES DEDUCTION**

The domestic production activities deduction (DPAD) is a federal tax deduction that was part of the American Jobs Creation Act of 2004, and became effective in 2005. It was a replacement for the extraterritorial income exclusion (EIE) which the World Trade Organization required the United States to repeal. The EIE was a tax deduction available to manufacturers. Therefore, the replacement was nicknamed “the manufacturing deduction.” Many tax professionals still use this moniker. But don’t be deceived by the terminology used. Your non-manufacturing business may qualify for the DPAD. The following businesses qualify for the deduction:

- Traditional manufacturers
- Engineering and architectural services
- Music recordings and film production
- Software development
- Electricity and natural gas
- Construction
- Unbottled drinking water production

The deduction is allowed for gross receipts derived from the sale, lease or rental of tangible personal property that is manufactured, produced, grown or extracted in whole or in “significant part” in the United States. “Significant part” means labor and overhead costs to manufacture and produce the product equal at least 20 percent of the product’s total cost.

The deduction is equal to a specified percentage of qualifying income from domestic production activities. For 2005 and 2006 the percentage was 3%. For 2007 through 2009 that doubled to 6% and reaches 9% in 2010. The deduction is limited to 50% of W-2 wages, as well as the taxable income for the year.

For example: a C corporation that had

\$1,000,000 of taxable income (all from qualifying activities, and W-2 wages of at least \$180,000) in 2009 would generate a deduction of \$90,000, and a tax savings of \$30,600.

Even though the EIE was replaced with the DPAD, the EIE deduction may still be claimed through 2006. And nothing precludes you from taking both deductions in 2005 and 2006. The requirements to claim the EIE deduction differ from the DPAD, but most traditional manufacturers (including film & music producers and software developers) that had some export profits will qualify for the EIE. There is still time to amend returns to claim any missed deductions.

### **CONSERVATION EASEMENT CONTRIBUTIONS**

Landowners that own scenic, environmentally sensitive, or historic properties may take advantage of a recently expanded tax deduction for charitable contributions of conservation easements. The easement is a binding agreement, typically made with a land trust, which permanently prevents or limits the development of the land.

The value of the income tax deduction is generally the reduction in value created by the easement. The land must be appraised with and without the easement.

The deduction is limited to 50% of your adjusted gross income (AGI) per year. Any excess may be carried over for 15 years. Career farmers and ranchers may be able to offset 100% of their AGI. These limits are up from 30% of AGI and a 5 year carryover. However, these increased benefits expire at the end of 2007.

Since the landowner still holds legal title

it is reportable on their estate tax return upon their death. However, the value would be reduced due to the easement. Granting such an easement may not only provide you with a significant tax benefit, it will also help preserve the environment.

## CALIFORNIA USE TAX AMNESTY

California has extended their use tax voluntary disclosure program (amnesty) through January 1, 2008. Generally, use tax applies when a person or business in California purchases tangible merchandise from a retailer outside of California that will be *used, consumed, given away, or stored* in California.

The tax is assessed on the “use” of tangible merchandise, hence it is called a use tax. A common example would be the purchase of artwork from outside of California, where sales tax was less than the California sales tax rate. The difference in the sales tax paid and the California sales tax would be payable as use tax. The imposition of use tax is also common in the purchase of equipment used in a business.

A qualifying taxpayer will limit the assessment period for prior years use taxes from the normal 10 years to 3 years. It is also possible for late filing and late payment penalties to be waived. An applicant may anonymously apply (through their CPA or attorney) and obtain a written opinion regarding whether their voluntary disclosure request may be approved.

A qualifying taxpayer must meet all of the following requirements.

- You reside in California and have not previously registered or filed a use tax return
- You are not in business as a retailer
- You have not been contacted for failure to report use tax
- Your purchase is not of a vehicle, vessel or aircraft
- You voluntarily come forward

You must apply for the amnesty using the proper Board of Equalization (BOE) applications. The BOE will process the application and assess the appropriate taxes, interest and penalties.

## DOING BUSINESS IN CALIFORNIA

A recent California State Board of Equalization (which

hears state income tax appeals) ruling illustrates the broad taxing authority the state is willing to impose.

In the Appeal of Destino Properties, LLC (adopted February 1, 2007) the Board ruled that the actions of the LLC’s California resident managing members constituted doing business in the state, which subjected the taxpayer to the minimum LLC tax of \$800. California Revenue & Taxation Code section 23101 defines “doing business” as “actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.”

The taxpayer’s (an LLC organized in Nevada) sole asset is a single-family home located in Henderson, Nevada, from which it receives rental income. Most of the management activities were handled from Nevada. However, the California resident members conducted the following activities from within the state (partial list).

- Employed a California tax professional
- Receiving, endorsing, and depositing rent checks
- Paid manager’s fee
- Managed the books and records
- Used a California business address for tax filings
- Claimed active participation for passive activity loss limitations
- Made decisions regarding expenses, including repairs and landlord fees

Further, the taxpayer failed to substantiate factual assertions regarding its activities conducted in Nevada.

The lessons in this case are many. First, if you are managing an out-of-state property from within California you may be subject to the annual LLC minimum tax. Second, if any of the managing members are California residents, be sure to substantiate that management activities are being handled from outside of California. Third, the taxing authorities will look at substance over form in your activities.

Interestingly missing from the Board’s written decision was any mention of the California gross receipts fee. Under existing California law (which is currently being challenged in court) the worldwide gross receipts of an LLC doing business in the state are subject to a fee. The only assumption we can make is that the gross receipts from the property did not exceed the \$250,000 floor.

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