Compound Your Way *to* ***Lower*** *Taxes*

Special deductions may help pharmacies save money

by Scott W. Sykes, CPA

Do you own a compounding pharmacy or compound a few medications in your store each day? If so, you already likely have good margins from this revenue stream, but you may also have a valuable tax deduction to utilize. That tax deduction is the domestic production activities deduction (DPAD), or Internal Revenue Service Code Section 199.

Section 199 gives a tax break to taxpayers who manufacture products for resale and who pay employees to assist in that manufacturing. Under current tax law, pharmacies that compound are considered manufacturers and are eligible for this deduction. Thankfully, there are no Food and Drug Administration or other technical compounding requirements or definitions that impact this area of the tax law. If you are a compounder, you qualify for DPAD if you meet the IRS limitations described in the following.

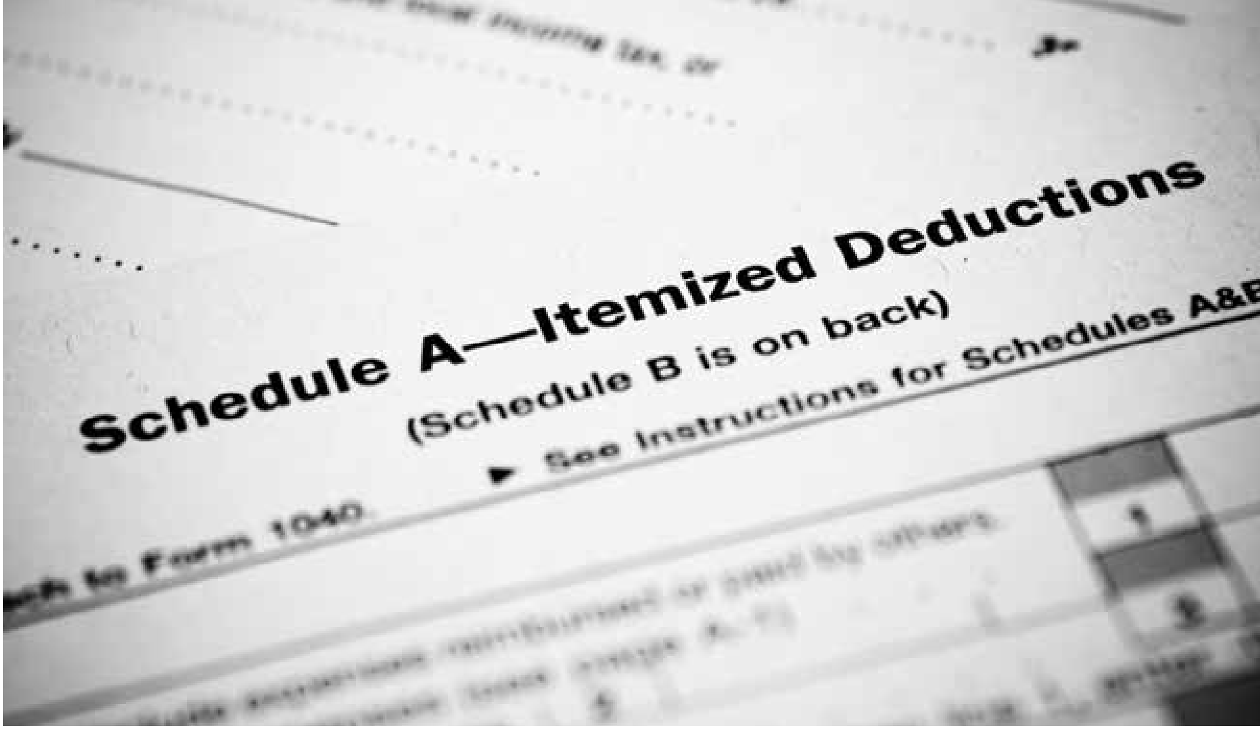
The deduction for 2010 and thereafter is 9 percent of whichever of these numbers is lower: taxable income or qualified production activity net income (QPANI). The deduction is also limited to 50 percent of the wages that are attributable to the manufacturing/compounding process. Let's look at these factors and examples of how much this could save you in taxes.

TAXABLE INCOME

Taxable income is simply your taxable income from the business as a whole. It includes all sales departments and expenses, including compounding. QPANI is your net income directly allocable to compounding. To calculate your QPANI, take your compounding revenue minus compounding cost of goods sold, minus compounding expenses (direct and indirect). Your net bottom line from this calculation is your qualified production activity net income from compounding. Revenues, cost of goods, and expenses attributable to other revenue streams such as prescription fills, durable medical equipment (DME), and over-the-counter (OTC) are not taken into consideration when calculating QPANI.

Once you've calculated your taxable income and QPANI, you must take into consideration the employee wage limitations. The deduction cannot exceed 50 percent of Form W-2 Medicare wages you paid allocable to compounding. Keep in mind that these are wages you paid directly allocable to employee(s) involved in compounding. In most instances, pharmacy owners do not track this information as some employees work in many areas of the pharmacy. As a result, many pharmacy owners use a reasonable method—which varies from pharmacy to pharmacy—to determine the allocation between compounding wages and other departments. Ideally, you want to track this wage category separately, and many payroll companies can easily assist you with this.

Let's look at an example. If you have QPANI of $100,000, taxable income of $310,000, and you paid your employees Form W-2 Medicare wages of $10,000 for compounding, your deduction is limited to $5,000 (or 50 percent) of $10,000. If wages were $20,000, the deduction would be $9,000, or 9 percent of QPANI ($100,000). A $9,000 deduction at a 35 percent tax rate can save you $3,150 in taxes.



Suppose you are a compounding-only pharmacy and you have QPANI of $300,000 and—since it is compounding-only—your taxable income is $300,000. You paid your employees Form W-2 wages of $250,000. As QPANI and taxable income are the same, 9 percent of this number would be $27,000. Taking 50 percent of your wages would be $125,000. Clearly, the $27,000 (or 9 percent of QPANI) does not exceed 50 percent of your wages. Therefore, your deduction is $27,000, and your tax savings at 35 percent is $9,450.

FACTORS TO CONSIDER

Before you jump ahead, there are some important considerations to review. The rules and calculations can be complex and time consuming, so the deduction may not be worth the effort and cost to compile and calculate if compounding is a small percentage of your overall revenue. Your tax advisor can assist you with making this determination. Other items to consider are net operating losses, multiple pharmacy entities that claim DPAD, and Section 481(a) adjustments. These should all be taken into consideration during the tax preparation process.

As is the case with most tax break opportunities, and especially this one, it's imperative that the proper accounting structure and fundamentals be in place to simplify this process at the end of the year. You must be able to track compounding revenues, cost of goods, and expenses separately. Pharmacies should be able to easily track and capture this compounding information daily in their accounting system. Tracking on a daily basis and coding the revenues and expenses to a separate compounding class makes year-end processing seamless and saves you time, costs, and headaches.

All eligible taxpayers are allowed to claim the deduction regardless of their tax entity status. S corporations, sole proprietors, single-member limited liability companies (LLCs), and partnership taxpayers all use adjusted gross income (AGI) to calculate the lesser of QPANI or AGI, and IRS Form 8903 is used to calculate the deduction. The deduction is reported on line 35 of IRS Form 1040. C corporations use taxable income on Page 1 of the tax return. C corporations report the deduction on line 25 of IRS Form 1120.

PROS AND CONS OF SEEKING PRIOR YEAR DEDUCTIONS

If you find out that you have been missing this deduction, you do have an option to ease your frustration. The IRS allows you to go back and amend your prior two-year tax returns to claim the deduction. However, keep in mind that amending prior year tax returns may increase your audit risk, so be careful when considering this option. Even if your tax returns are perfect, an audit is not a fun process, so the drawbacks may outweigh the benefits. Additionally, if you have been missing this deduction and are eligible for it, you may want to consult with a tax advisor who understands this deduction and how it applies to pharmacies.

As with any tax strategy, it is important to perform your due diligence and review with your advisors before moving forward. If proper accounting is in place and compounding revenues make the calculations worthwhile, it shouldn't be too complex, stressful, or difficult for a pharmacy to calculate and take advantage of this valuable deduction. ■

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