



Real Estate & the New Manufacturers' Deduction

By Mary F. Bernard, CPA

Construction Industry Receives a Boost!

In October 2004, a significant piece of tax legislation, the American Jobs Creation Act of 2004, was enacted. This led to a completely new concept in the taxation of US manufacturers, construction companies and engineering and architectural firms.

Although the name of the deduction indicates that the emphasis is on manufacturers, its application to construction companies, homebuilders, land developers, general contractors and subcontractors involved in construction on United States real property is significant. New proposed regulations issued in January 2006 have addressed the construction industry issues involved with this deduction.

Requirements

In order to qualify for the deduction, the construction activities must be directly related to the erection or substantial renovation of US real property.

For purposes of this deduction, real property includes the following:

- 1) Residential and commercial buildings, including structural components of those buildings;
- 2) inherently permanent structures other than tangible personal property in the nature of machinery;
- 3) inherently permanent land improvements; and
- 4) infrastructure, including roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, wiring, as well as inherently permanent oil and gas platforms.

Substantial renovation of property is further defined as the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or

adapts that property to a new or different use. Mere cosmetic changes such as painting would not be considered substantial renovation.

An additional requirement is that a contractor's construction activities must be performed as a trade or business in which the contractor is engaged on a regular and ongoing basis. It need not be his only or primary occupation, but it must be regularly carried on.

Because this deduction is based on the calculation of a specific kind of net income, many accounting issues arise. First the decision needs to be made as to whether or not the activities of the business fall within the definition of domestic production activity income. Then, gross receipts from qualifying activities must be segregated from those that do not qualify and appropriate allocation of expenses must be made between the two types of income. This is far from simple once you begin to consider "directly allocable" expenses as well as the proper share of "indirect" costs to allocate. As much of these allocations will be subjective, it is expected to be an area of conflict.

Qualified Production Activities Income

The production incentive included in the Act effectively creates two distinct types of US income: qualified production activities income (QPAI) and all other income. The Act defines QPAI as the taxable income derived from qualified activities. In construction activities, this would include all proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer. QPAI does not include any proceeds from the portion of the sale attributable to the land unless the cost of the land is less than 5% of the total project costs.

Deduction Calculation

In addition to the actual deductible business expenses incurred, a percentage of the taxable income generated from domestic production activity would be an additional deduction. This taxable income number is calculated by taking the gross receipts generated from the qualifying activity and deducting both the cost of goods sold directly allocable to these receipts as well as a portion of the expenses indirectly allocable to the activity. In general, it would be advantageous to maximize the gross receipts applicable to the qualifying activity and to maximize deductions attributable to non-qualifying activities in order to obtain the highest deduction.

Good News, Bad News

For 2005, the deduction available is calculated as 3% of the lesser of QPAI for the year or taxable income. However, this deduction is further limited to 50% of the W-2 wages of the employer for the tax year. These two limitations make this incentive less attractive to entities with taxable losses as the deduction is not allowed to increase a net operating loss. In addition, companies with wages that are relatively low when compared to profits will not benefit greatly from this deduction.

More Good News

One major benefit for homebuilders, general contractors and subcontractors is a rule that is applicable only to construction activities. More than one taxpayer may be regarded as constructing real property with respect to the same activity and the same construction project. For example, if X is a general contractor who hires Y, the subcontractor, to install a roof on a new building, both X & Y are eligible for the production activities deduction based on their respective percentage of the activity.

Bad News

It should be noted that rental income derived from property constructed by the taxpayer is **not** considered income subject to this deduction. Only leases or rentals of tangible personal property, computer software, or sound recordings would qualify. Any income generated from the sale of land is also not eligible for the deduction. This issue has generated discontent in the industry, especially in the area of allocating costs to the land to determine if 95% of the total construction costs relate to building costs. This will definitely boost the businesses of real estate appraisers if every finished lot sold to homebuilders must exclude gross receipts from the sale of land and related appreciation.

State Treatment

As of early 2006, twenty-eight states have agreed to allow the deduction for state purposes. Rhode Island and Connecticut allow the deduction but Massachusetts and New Hampshire do not. This could mean that any tax savings realized by this deduction could be available only at the federal level.

The Future

The percentage of the deduction increases until full implementation in 2009 at 9% deduction. There are still many unanswered questions related to the calculation and availability of this deduction that may not be answered immediately. The complexity of the rules alone could be counterproductive for small businesses trying to comply with the rules and enjoy the tax benefits. The allocation of costs could be a paperwork nightmare, thus decreasing the implementation of this benefit. Whatever the administrative burden might be, it is clear that this deduction should be especially appreciated by taxpayers involved in the construction industry.

About the Author – Mary F. Bernard, CPA, MST:

Ms. Bernard joined the firm early in 1994, bringing a solid background in all phases of tax planning and compliance. She has over twenty years of experience with national and local accounting firms working with a variety of individual, partnership and corporate clients. She has provided advisory and compliance services to non-profit and construction clients.

She earned a Bachelor of Arts degree in Mathematics from Bridgewater State College (MA), a Master of Arts degree in Accounting from Bentley College, (MA), and a Master of Science degree in Taxation from the University of Hartford (CT).

Ms. Bernard is a member of the AICPA, the Massachusetts Society of CPAs, and serves as Vice President of the board of directors for the Rhode Island Society of CPAs. She also serves as Treasurer of the Rhode Island Council on Alcoholism and Other Drug Dependence. She has recently been appointed a Member of the AICPA Council.