STEPTOE & JOHNSON LLP

NEW SECTION 199 DOMESTIC PRODUCTION DEDUCTION AND HOW IT APPLIES TO THE CONSTRUCTION AND REAL ESTATE INDUSTRY

By
Pat Derdenger, Partner
Steptoe & Johnson LLP
201 E. Washington Street, 16th Floor
Phoenix, Arizona 85004-2382
(602) 257-5209
e-mail: pderdenger@steptoe.com

How to Structure the Real Estate Deal in Arizona
Prepared for: Lorman Educational Services
Thursday, May 3, 2007
Phoenix, Arizona

STEPTOE & JOHNSON LLP

Washington, D.C. *Phoenix* *Los Angeles* *Chicago* *New York* *London* *Brussels*

NEW SECTION 199 DOMESTIC PRODUCTION DEDUCTION AND HOW IT APPLIES TO THE CONSTRUCTION AND REAL ESTATE INDUSTRY

By
Pat Derdenger, Partner
Steptoe & Johnson LLP
201 East Washington Street
16th Floor
Phoenix, Arizona 85004-2382
(602) 257-5209
e-mail: pderdenger@steptoe.com

STEPTOE & JOHNSON LLP

Washington, D.C. Phoenix Los Angeles Chicago New York London Brussels

1. INTRODUCTION

This document outlines the new domestic production federal income tax deduction. This synopsis is meant as an introduction. Consequently, it does not explain how to calculate the deduction for any particular taxpayer or business form. Nor does it fully explore some of the deduction's more complex attributes. This document does, however, outline the basic operation of the deduction and its applicability to the construction industry.

Congress added the domestic production deduction to the Internal Revenue Code ("Code") as part of the American Jobs Creation Act of 2004. Pub. L. No. 108-357, 118 Stat. 1424 (codified at 26 U.S.C. § 199) (attached as Tab A). In 2005, Congress amended Section 199 to both clarify and expand on concepts included in the original act. Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, 119 Stat. 2615 (2005); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345.

The domestic production deduction replaces the old foreign sales corporation/extraterritorial income regime, which created an incentive for US manufacturers who produced and exported goods. While creating a similar incentive, the new deduction has broader application because it focuses on all domestic production rather than production related to solely to exportation.

The Internal Revenue Service and the US Department of Treasury promulgated proposed regulations in November 2005. With some changes, those regulations were finalized and adopted in May of this year and became effective on June 1. The new regulations will be codified at 26 C.F.R. §§ 1.199-1 through 1.199-9.

2. THE DOMESTIC PRODUCTION DEDUCTION IN A NUTSHELL

Effective for tax years beginning after December 31, 2004, Section 199 provides a special deduction for domestic production activities that qualify under the statute. The deduction is calculated as a *percentage of the lesser of either (1) the taxpayer's total taxable income or (2) the net income derived from qualifying production activities*. 26 U.S.C. § 199(a)(1). Section 199 phases in the full deduction between the 2005 and 2010 tax years. For 2005 and 2006 the deduction is 3%. For 2007-2009 the deduction is 6%. Beginning in 2010, the deduction is 9%. § 199(a)(2). The statute, however, limits the deduction for any tax year to 50% of the taxpayer's W-2 wages paid during the tax year.[1] § 199(b); 26 C.F.R. § 1.199-2.

The deduction applies to any size business or business form including corporations, individuals and pass-through entities such as partnerships, Subchapter S corporations and estates and trusts. However, the methods of calculating the deduction will vary depending on the business form. § 199(d). In its simplest form, the deduction may be summarized as follows:

Deduction (Not to Exceed 50% of Taxpayer's W-2 wages paid during the tax year).	=	3% (2005-2006) 6% (2007-2009) 9% (beginning in 2010)	X	The *lesser* of: (1) the net income derived from qualifying production activities OR (2) total taxable income.

While this simple description captures the basic form and function of the Section 199, further explanation of the terminology and the deduction's attendant calculations is necessary before outlining Section 199's applicability to the construction industry. Under Section 199's terminology, the taxpayer's net income from qualifying activities is called "Qualified Production Activities Income" ("QPAI"). QPAI forms the primary base upon which the deduction is calculated.

The statute precisely defines QPAI as the taxpayer's ***"domestic production gross receipts"*** ("DPGR") minus the sum of (1) the costs of goods sold that are allocable to those receipts and (2) the other expenses, losses and deductions (other than the domestic production deduction itself) allocable to those receipts. § 199(c)(1). The final regulations provide guidance on allocating the costs related to DPGR. 26 C.F.R. § 1.199-4.

---

[1] The Internal Revenue Service has issued a Revenue Procedure (attached as Tab B) detailing the proper methods for various business forms to calculate their W-2 wages for the purposes of Section 199. See I.R.S. Rev. Proc. 2006-22, I.R.B. 2006-22 (CCH) ¶ 46,447 (May 24, 2006).

Further, Section 199 defines DPGR to include only gross receipts that derive from a specific set of qualifying activities. Consequently, the applicability of Section 199 to any given taxpayer depends on the nature of its business activities. Put another way, the type of income earned by the taxpayer drives eligibility for the Section 199 deduction. § 199(c)(4).

3. THE DOMESTIC PRODUCTION DEDUCTION IS AVAILABLE TO THE CONSTRUCTION INDUSTRY BECAUSE GROSS RECEIPTS FROM MOST CONSTRUCTION PROJECTS CONSTITUTE DPGR.

Despite being billed as a manufacturing incentive, Section 199, by its own force, broadly applies to the construction industry. Generally, taxpayers earning any one of three categories of income qualify for the deduction. First, gross receipts derived from the sale, lease, license or exchange of tangible personal property (products) substantially manufactured, produced, cultivated or extracted by the taxpayer within the United States qualify as DPGR. This category covers traditional manufacturing and statutorily includes products such as films as well as electricity, natural gas and potable water produced within the United States. However, the statute excludes gross receipts both from the retail sale of food and beverages in restaurants and from transmission or distribution of electricity, natural gas or potable water. *Id;* § 199(c)(4)(A) & (B).

Second, gross receipts from architectural and engineering services provided in conjunction with domestic real property construction projects is considered DPGR if certain requirements are met. § 199(c)(4)(A)(iii); 26 C.F.R. § 1.199-3(n). Finally, gross receipts from construction projects also qualify as DPGR if taxpayers meet certain requirements. § 199(c)(4)(A)(ii); 26 C.F.R. § 1.199-3(m) (see attached Tab C). The requirements for construction DPGR are discussed below.

3.1 <u>Most Residential and Commercial Contractors, Subcontractors, and Developers Will Qualify for the Section 199 Deduction Because They Will Have Income That Satisfies the Statutory and Regulatory Definitions of DPGR.</u>

As a general mechanical note, taxpayers must make the determination whether receipts qualify for the deduction on any reasonable item-by-item basis, but not on some other basis such as by corporate division, product line or transaction. 26 C.F.R. § 1.199-3(d)(1). For the construction industry, the determination of what constitutes and item will be made on a case-by-case basis based on all the facts and circumstances. § 1.199-3(d)(2). The determination of what constitutes an item will bear on both taxpayer eligibility for the deduction and the availability of certain safe harbor and de minimis rules discussed below.

Taxpayers in the construction industry qualify for the deduction, i.e. have DPGR, if the following requirements are met:

- The taxpayer's activity must be "construction."
- The construction must be of "real property."
- At the time of construction, the taxpayer must be actively engaged in a construction trade or business.
- The construction project must be performed in the ordinary course of the taxpayer's trade or business.
- The construction must be performed by the taxpayer within the United States.
- The taxpayer's gross receipts must derive from the construction activity. § 199(c)(4)(A)(ii).

The Department of Treasury's final regulations further clarify the statutory requirements and define the relevant terms. Each of these requirements, as established in the final regulations is discussed in turn below.

(1) Taxpayer Must Be Engaged in an Activity That Meets the Statutory and Regulatory Definitions of "Construction".

Section 199's attendant final regulations define construction generally as "the erection of real property in the United States." § 1.199-3(m)(1)(i). For deduction purposes, most activities commonly required to build and substantially renovate real property, including the managerial functions of general contractors, constitute construction activities. § 1.199-3(m)(2). Substantial renovation requires that the taxpayer renovate a major component or substantial structural part of real property; the renovations must also materially increase the property's value, substantially prolong the property's useful life or convert the property to a new or different use. § 1.199-3(m)(5). Put another way, substantial renovation generally includes permanent improvements for which the cost is capitalized to the property. I.R.S. Notice 2005-14, §3.04(11)(d), I.R.B. 2005-7 (Jan. 19, 2005). But, cosmetic changes such as painting or redecorating do not constitute substantial renovation. H.R. Conf. Rep. No. 108-755 (CCH) ¶ 12,468.80.

The regulations, however specifically exclude construction equipment rental and architectural and engineering services from the definition of construction activities.[2] *Id.* Furthermore, a significant number of activities essential to most building projects may or may not meet the definition of construction depending on who performs them and the context in which they are performed. For example, tangential services, such as hauling debris or delivering

---

[2] As noted above, however, architectural and engineering services qualify for the domestic production deduction in their own right. *See* 26 U.S.C. § 199(c)(4)(A)(iii); 26 C.F.R. § 1.199-3(n).

materials, are not construction activities *unless* they are performed in connection with a project on which the taxpayer also performs construction. *Id.* Similarly, administrative services such as billing and secretarial services constitute a construction activity when they are undertaken by a builder/contractor in connection with its project. *Id.* Finally, improvements and services, such as landscaping, painting, clearing, grading, demolition and excavation do not qualify as construction activities on a stand alone basis. They do, however, constitute construction activities when performed in conjunction with erection or substantial renovation of real property. *Id.*

(2) The Construction Must be of "Real Property."

The final regulations define "real property" as (1) residential and commercial buildings including structural components of these buildings, (2) inherently permanent structures that ordinarily affix to real property over time such as swimming pools, fences, outdoor lighting, parking lots and driveways, (3) inherently permanent land improvements, (4) oil and gas wells and (5) infrastructure, such as roads and sidewalks, power lines, water and sewer systems and communications facilities, cable and wiring. § 1.199-3(m)(3) & (4).

However, tangible personal property, such as appliances, furniture and fixtures, that are sold as part of completed construction projects, does not meet the regulatory definition of real property. § 1.199-3(m)(1)(i). Furthermore, state law does not control the real property determination. Thus, items considered real property under state law may not qualify as real property for Section 199 purposes and vice versa. *Id.*

(3) At the Time of Construction the Taxpayer Must Actively Engage in a Construction Trade or Business as Defined by the North American Industry Classification System on a Regular and Ongoing Basis.

To take advantage of the domestic production deduction, the taxpayer must, at the time of its construction project, be actively engaged in a trade or business that the North American Industry Classification System ("NAICS") categorizes as construction. § 1.199-3(m)(1)(i). However, the NAICS-recognized trade or business need NOT constitute the taxpayer's primary or only trade or business for purposes of the Section 199 deduction. NAICS lists most of the construction categories under the two-digit code of 23 (see attached Tab D), but other code sections may satisfy this requirement if they relate to oil and gas drilling and construction. *Id.* Finally, the regulations make the determination of whether a taxpayer falls within a certain NAICS classification on an entity-by-entity basis. Consequently, in an affiliated group of corporations, the construction activity of one affiliate may not be attributed to another affiliate for deduction purposes. § 1.199-7(a)(3)(ii).

The final regulations also require the taxpayer to engage in the construction trade or business on a regular and ongoing basis. § 1.199-3(m)(1)(i).

Despite this requirement, the regulations recognize that in the construction industry taxpayers often form entities to complete specific construction projects and then dissolve those entities upon completion. Concerned that project-specific entities might not satisfy the regular and ongoing basis requirement, the final regulations provide a safe harbor for these types of entities based on when the construction project is sold. Under the safe harbor, a taxpayer is deemed to have met the regular and ongoing basis requirement if it "derives gross receipts from an unrelated party by selling or exchanging the constructed real property" within five years (60 months) of a project's completion date. § 1.199-3(m)(1)(ii)(A).

The regulations also create a safe harbor from the regular and ongoing basis requirement for newly-formed organizations in their first year of operations. § 1.199-3(m)(1)(ii)(B). These organizations will satisfy the requirement if they reasonably expect to engage in a construction trade or business on an ongoing basis. *Id.*

(4) Taxpayer Must Actually Perform the Work Within the United States.

As a *domestic* production deduction, Section 199 quite obviously will only apply to construction projects within the United States. Furthermore, the taxpayer seeking the deduction must actually perform or be responsible for the construction activity. This requirement may not be satisfied where a taxpayer regularly engaged in the construction trade under NAICS purchases a building, hires an unrelated general contractor to oversee a substantial renovation and then sells the renovated building. The proceeds from this sale do not qualify as DPGR because the taxpayer did not engage in a construction activity. The general contractor, however, does qualify for the deduction because its gross receipts derive from a construction activity. *See* § 1.199-3(m)(6)(v) (Example 1).

(5) Gross Receipts Must Derive From Construction -- The Value of the Underlying Land is Excluded.

Under Section 199 and the final regulations in order to qualify for the deduction, the taxpayer's gross receipts must derive from the construction activities themselves. This limitation will exclude certain gross receipts even though they may be earned in conjunction with or as a result of a construction project.

In general, gross proceeds from the sale of constructed real property, from construction contract services, from the contractor's mark-up on materials used in the project, and from qualified construction warranties qualify for the deduction. The final regulations state that gross receipts from the sale, exchange or other disposition of property constructed by the taxpayer qualify for the deduction, regardless of whether the project is completed before sale or if the sale occurs immediately after project completion. § 1.199-3(m)(6)(i). Gross proceeds from construction services performed by contractors and subcontractors qualify for the deduction. *Id.* In this regard, Section 199 treats construction contractors differently than contract producers of tangible personal property because it does not require the construction contractors to bear the benefits and burdens of property ownership in order to qualify for the exemption. *See* § 1.199-3(f)(1). Furthermore, gross receipts derived from the contractor's mark-up on materials that are either consumed in the construction project or that become part of the completed real property also qualify for the deduction. *Id.* This last inclusion reflects a 180 degree shift between the proposed and final regulations. Finally, gross receipts that represent the value of a construction warranty qualify for the deduction as long as the taxpayer normally offers an automatic warranty in the regular course of doing business, the price for the warranty is not separately stated or identified, and the warranty is not separately bargained for. § 1.199-3(m)(6)(ii).

However, certain transactions engaged in by taxpayers do not qualify for the Section 199 deduction even though the taxpayer constructed the subject real property. For example, gross proceeds from the sale of property that the taxpayer originally constructed, sold, and then reacquired do not qualify for the deduction. § 1.199-3(m)(6)(iii). Similarly, lease or rental income on property that the taxpayer constructed does not qualify for the deduction because the taxpayer receives that compensation for the use or forbearance of use of the property. *See* I.R.S. Notice 2005-14, § 3.04(11)(e), I.R.B. 2005-7 (Jan. 19, 2005).

Finally some of the value that inheres in gross receipts derived from many construction projects does not become part of the income on which the taxpayer may base a deduction – most notably the value of the land and entitlements. Under the final regulations, gross receipts derived from the sale of land, which includes zoning, planning, entitlement and other soft costs capitalized to the land do not qualify for the deduction, even when the land is sold in conjunction with buildings that constitute DPGR. § 1.199-3(m)(6)(iii). However, the regulations provide a safe harbor for valuing the land as discussed below.

Under these requirements, definitions, and regulations, the Section 199 deduction has broad applicability in the construction industry. Most residential and commercial building contractors, including re-modelers, may take advantage of the deduction. Likewise, electrical and HVAC subcontractors may also take advantage of the deduction. Furthermore, both general contractors and subcontractors may take the deduction on the same construction project. *See* § 1.199-3(m)(6)(v)(Example 1). Based on both the primary deduction formula and the calculation of QPAI as outlined above, allowing deductions to both the general and subcontractor does not result in two deductions with respect to the same receipts because the subcontractor's gross receipts represent a cost for the general contractor.

3.2 De Minimis Rules and Safe Harbors for the Construction Industry.

As noted above, DPGR is determined on an item-by-item basis. For any item, construction project or subcontract on a construction project, the taxpayer may earn both DPGR and non-DPGR receipts. This situation will commonly arise with respect to those in the construction industry who own their projects' underlying land, such as spec builders and developers. In addition to the safe harbor for construction warranties discussed above, the final regulations also contain a de minimis rule for non-DPGR receipts and a land safe harbor.

(1) The Five Percent De Minimis Rule.

Because Section 199 increases the administrative burden on taxpayers by forcing them to allocate gross receipts between DPGR and non-DPGR, the final regulations contain a rule to lessen this burden for taxpayers who have minimal amounts of DPGR or non-DPGR for any given item or project. Under this rule, if a taxpayer earns less than five percent of its gross receipts on an item from activities other than the construction, such as by providing tangential services or selling the land or other tangible personal property along with the construction project or services, the taxpayer may treat all its gross receipts from the item as DPGR. § 1.199-3(m)(1)(iii).

(2) The Land Safe Harbor.

Like the provision discussed above, the land safe harbor is intended to reduce the administrative burdens of valuing the gross receipts attributable to the land in connection with other qualifying construction projects. Dep't of Treasury, Notice of Proposed Rulemaking REG-105847-05 (Nov. 4, 2005) (CCH) ¶ 49,668. This safe harbor applies when a taxpayer's gross receipts for an item include receipts for both land and real property construction as defined in the regulations. In this situation, the taxpayer may allocate gross receipts between the two by reducing its DPGR costs by the cost of the land itself, entitlement costs capitalized to the land and other capitalized costs or costs of common improvements. The taxpayer also reduces its DPGR by those costs plus a percentage based on the number of years the taxpayer held the land. The taxpayer may add 5% if it held the land for one to five years, 10% if it held the land for five to ten years and 15% if it held the land for ten to fifteen years.

For example, suppose a developer regularly engaged in a construction trade purchases 1,000 acres of land on June 1, 2007 for $60 million including entitlement costs. The developer then builds 1,000 homes on ½ acre lots and installs common improvements such as streets, clubhouses, tennis courts, swimming pools and playgrounds. The cost of construction for each house is $170,000. The costs of common improvements are $55,000 per house, $30,000 of which is attributable to land. And, the cost of land for each ½ acre lot on which a house is located is $30,000. Thus, the total cost for each house is $255,000.

If the developer then sells the first home on January 31, 2012 for $300,000, the developer's cost of goods sold allocable to DPGR is $195,000 ($255,000 minus the cost of the land). Its DPGR is $237,000 ($300,000 minus the cost of the land plus 5% or $63,000). Thus, the developer's QPAI is $42,000.

If the developer sells another home in 2014 for $300,000, the cost of goods sold allocable to DPGR remains the same at $195,000. Its DPGR, however, is reduced to $234,000 ($300,000 minus the cost of land plus 10% or $66,000). Thus, QPAI is $39,000. *See* 26 C.F.R. § 1.199-3(m)(6)(v)(Example 5).

4. THERE ARE SPECIAL RULES FOR DETERMINING THE DEDUCTION FOR AFFILIATED ENTITIES AND CONSOLIDATED GROUPS THAT MAY AFFECT A TAXPAYER'S APPROACH TO ARIZONA'S MARKETING ARM - CONTRACTING ARM STRUCTURE.

Section 199 contains two distinct affiliated entity concepts – and Expanded Affiliated Group ("EAG") and a consolidated group. Section 199 defines both groups with reference to Section 1504(a)'s requirements for consolidated reporting, but uses different stock ownership thresholds. § 199(d)(4)(b); Reg. 1.199-7(a)(1) (attached as Tab ____).

A group of affiliated corporations constitutes an EAG if it has a stock ownership threshold of more than 50%, whereas a consolidated group has a stock ownership threshold of at least 80%. *Id.* Thus, an EAG, for Section 199 purposes, may contain both consolidated and non-consolidated entities. Where an EAG qualifies for a Section 199 deduction, the Code treats the entire EAG as a single taxpayer. § 199(d)(4)(A).

(a) Determining The Deduction For EAGs And Consolidated Members.

While treated as a single corporation, an EAG determines its Section 199 deduction in the following manner. Each member separately determines its own taxable income and loss, QPAI, and W2 wages. These figures are then aggregated. Reg. 1.199-7(b). A consolidated group, however, determines its deduction based on its consolidated taxable income and loss, QPAI, and W2 wages. Reg. 1.199-7(d)(4). Where an EAG contains both consolidated and non-consolidated members, the consolidated group is treated as a single member of the EAG and its figures are aggregated with the other members'. *Id.*

(b) Construction Activities Are Not Attributable To The Disposing Member Of an EAG, But They Are Attributable To The Disposing Member In A Consolidated Group.

Normally, the qualifying activities of one member of an EAG are attributable to another member. Reg. 1.199-7(a)(3)(i). For example, if one member of an EAG manufactures equipment and another member of the EAG purchases and then resells that equipment at wholesale or retail, the latter member's gross receipts on the wholesale or retail sale of the equipment constitute DPGR. The former member's previous manufacturing activities are attributed to the latter member. *Id.* (example 2).

This attribution rule, however, *does not apply to construction activities at the EAG level.* Reg. 1.199-7(a)(3)(ii). Thus, a builder who constructs a home and sells that home to a non-consolidated member of an EAG for ultimate sale to the home buyer earns DPGR for all qualified construction activities. But, the gross receipts of the member who sells the finished home to the homebuyer *do not constitute* DPGR.

For consolidated groups, however, the attribution rule applies to construction activity. Consequently, if the two entities discussed in the previous example report on a consolidated basis, the builder's activities are attributed to the seller.

(c) Implications For Arizona's Marketing-Arm/Contracting-Arm Structure.

Based on the attribution rules, the Section 199 deduction will be greater for a consolidated marketing-arm/contracting-arm structure. Where the two entities are related by between 50% and 80% ownership, the group's QPAI will only be the contracting arm's sales price to the marketing arm less construction costs. Where the entities report on a consolidated basis, the group's QPAI will be the final sales price to the consumer less construction costs.