The Devil Is In the Details

New tax deduction for construction businesses

Tax codes are a lot like building codes: the devils, and the dollars, are in the details. Consider the IRS’s new Domestic Production Activities (DPA) deduction. This tax break, which applies to income from construction activities, allows builders to take a deduction equal to three percent of qualifying incomes in 2005 and 2006; six percent in 2007, 2008 and 2009; and nine percent from 2010 on.

What kinds of construction-related income qualifies for the DPA deduction?

Qualifying construction activities.

Qualifying income includes all income from real property construction in the United States. According to the IRS, real property construction includes the construction of:

• residential and commercial buildings (Note to condo converters: “construction” includes both new construction and “substantial renovation”)

• other “inherently permanent structures” (probably including outdoor lighting and advertising displays, but not including machinery),

• “inherently permanent land improvements” (probably including swimming pools, parking areas, and fencing), and

• infrastructure (e.g., power lines, water and sewer systems, sidewalks, and cable lines).

Qualifying income may be generated by a construction project for the developer-owner as well as the contractors and subcontractors working on the project, as long as each is engaged in qualifying activities with respect to the project. To assist in establishing that your company is engaged in a construction business, it is best if your company’s tax return shows a “business code” number beginning with 236, 237, or 238. (These numbers correspond to the three “Construction” categories within the North American Industry Classification System.)

The IRS takes the position that the DPA deduction is available only to taxpayers that are “in a construction business.” Thus, if a hotel owner/operator hires a contractor to renovate a hotel building and then sells the building, the contractor’s profit will qualify for the DPA deduction but the owner’s profit – according to the IRS – will not. On the other hand, if a person engaged in a construction business buys the building in its original condition and sells it after the renovation, the entire profit will qualify for the DPA deduction.
Treatment of construction-related service activities.

Income from service activities like painting and landscaping qualifies for the DPA deduction if the services are performed in connection with a real property construction project. Income earned by engineers and architects in connection with real property construction projects also qualifies. Income earned by other professional service providers probably does not.

Treatment of personal property sold with a building.

If five percent or more of the gross receipts from a construction project are attributable to the sale of personal property rather than real property (e.g., appliances sold with a home), the income attributable to the personal property must be excluded from qualifying construction-related income. This may result in some tension between builders and buyers of commercial buildings. Buyers frequently perform "cost segregation" studies with a view toward classifying a significant part of the building’s components as personal property eligible for accelerated depreciation benefits. If a buyer treats 15 percent of the cost of a building as attributable to personal property, but the builder treats the entire profit from the construction project as qualifying real property construction income, the IRS can be expected to challenge both the buyer and the seller. It may be best for the contracting parties to agree in advance as to how the contract price will be allocated.

Interestingly, income earned by subcontractors from the installation of building components that are treated as personal property (e.g., dedicated wiring or cooling systems for computer rooms) may qualify as construction-related income even if the owner-developer’s profit from the installation does not qualify. This is because the subcontractors are performing services in connection with a qualifying construction project and they are not selling personal property.

Profits from the sale of land.

The IRS currently takes the position that profits from the sale of land do not qualify for the DPA deduction. That position is under attack by the construction industry and may be modified. Nonetheless, land developers should be aware of the possibility that only contractors, and not owner-developers of land, will be able to claim the DPA deduction for profits attributable to constructing land improvements. (Owners’ profits from constructing land improvements may not qualify because they are realized on the sale of the land.) Possibly, this problem can be avoided by using separate entities for construction services and land ownership. The owner entity can compensate the construction entity for services performed. Rental income. The IRS currently takes the position that income from renting constructed real property is not “derived from construction.” However, gain from a post-lease-up sale of constructed property may qualify.

How is the DPA deduction computed? The DPA deduction is computed in a four-step process.

Step 1: Identify your gross receipts from qualifying activities for the year.

Step 2: Reduce qualifying gross receipts by your related cost of goods sold and by business expenses you incurred during the year that are allocable to your qualifying construction activities. (Note: If you can allocate business expenses to other activities, you can increase the amount of the DPA deduction.)

Step 3: Multiply nine percent (three percent for 2005-06; six percent for 2007-09) by the lesser of (1) the Step 2 result and (2) your overall taxable income (adjusted gross income in the case of an individual taxpayer).

Step 4: Reduce the Step 3 result to the extent it exceeds 50 percent of the "W-2 wages" you paid during the year.

Does your organizational structure affect your DPA deduction?

Organizational structure will have a significant impact on the amount of a contractor’s DPA deduction. Under the new law, if a qualifying business activity is conducted through a
passthrough entity (a partnership, LLC, or S corporation), the entity reports all of the relevant items to the owners, but it is the owners who compute and claim the deduction. This means that, if you own an interest in one or more passthrough entities that are engaged in construction activities, you will take into account your share of the relevant items of each entity (i.e., qualifying gross receipts, cost of goods sold, allocable expenses, and W-2 wages) and then aggregate those items with your relevant items from other activities.

There are two special rules for passthrough entities. First, the amount of a passthrough entity’s W-2 wages that may be taken into account by an owner is limited so that the owner can’t use the wages paid by the entity to increase the owner’s DPA deduction for qualifying income earned outside the entity. Second, the owner’s gain or loss from selling an interest in the entity is simply ignored and won’t affect the amount of the owner’s “qualified production activities income.”

Because of the passthrough entity rules, organizational structure will have a significant impact on the amount of the DPA deduction.

For example, a self-employed painting contractor who does not pay wages to employees will not be eligible for the deduction. However, if she forms an S corporation and pays herself a reasonable salary, any remaining income may be eligible for the deduction.

Passthrough entities also may provide opportunities to shift the deduction between entity owners. For example, in some circumstances, an out-of-state investor in an LLC constructing a spec building may want to avoid state income taxes by selling its interest in the LLC before the LLC sells the building. That investor will not be eligible for the DPA deduction with respect to its profit. Suppose, however, that the purchaser of the interest resells or liquidates the interest after the LLC sells the building – the purchaser may simply break even on the purchase and resale but may generate a DPA deduction based on the investor’s share of the LLC’s profit.

The bottom line

The DPA deduction will increase after-tax returns from construction projects. Every developer, builder, and contractor should consult a tax expert to find out how to maximize benefits under the new law.

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