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Regulations Proposed For Manufacturers

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As part of the "American Job Creation Act of 2004," Congress added Internal Revenue Code section 199, incorporating new incentives for United States domestic manufacturers. On January 19, 2005, the IRS and Treasury Department issued Notice 2005-14 providing interim guidance on section 199 and inviting comments on issues arising under section 199. Then, on November 4, 2005, the Treasury Department and IRS issued proposed regulations interpreting this provision. Under section 199, a deduction of up to 9% of "qualified production activities income" is available to taxpayers engaged, among other things, in manufacturing, construction, or the performance of architectural or engineering services.

Computation of "Qualified Production Activities Income"

The base for computation of the deduction is "qualified production activities income," which is, in general, an amount equal to "domestic production gross receipts," less certain costs and expenses attributable to those gross receipts. Domestic production gross receipts include the gross receipts of the taxpayer from (among other activities) (i) the lease, sale or other disposition of tangible personal property that was manufactured by the taxpayer in significant part within the United States, (ii) "construction performed in the United States," or (iii) engineering or architectural services performed in the United States for construction projects in the United States. Under Notice 2005-14 and the proposed regulations, "construction" includes activities that are directly related to the erection, structural improvement, or other substantial renovation of residential and commercial buildings and infrastructure.

Although receipts derived from the rental of certain property manufactured within the United States may qualify as domestic production gross receipts, rental receipts from real property do not so qualify.

In order to compute qualified production activities income, domestic production gross receipts must be reduced by (1) the cost of goods sold allocable to these gross receipts and (2) other deductions, expenses, or losses which are properly allocable to these gross receipts.

Limitations on Deduction

The deduction allowed by the new provision is generally equal to 3% (in 2005 and 2006), 6% (in 2007, 2008, and 2009), and 9% (thereafter) of the taxpayer's qualified production activities income. However, there are two significant limitations placed on the amount of the deduction.

First, the deduction cannot exceed 3%, 6%, or 9%, whichever is applicable, of the taxpayer's taxable income for the year in question, determined without regard to section 199. This limitation will come into play when the taxpayer's other activities, *i.e.*, other than domestic production activities, are generating a loss, rather than income, and will prevent the taxpayer from obtaining the benefit of the section 199 deduction with respect to income that is being sheltered by other losses.

The second limitation imposed by section 199 is that the deduction cannot exceed 50% of the wages paid by the taxpayer during the taxable year that are required to be included on Forms W-2.

Construction Activities

The proposed regulations provide that "activities constituting construction include activities performed in connection with a project to erect or substantially renovate real property, but do not include tangential services such as hauling trash and debris, and delivering materials, even if the tangential services are essential for construction."

Generally, gross receipts derived from the sale of tangible personal property not manufactured by the taxpayer, or from nonconstruction activities, do not qualify. Under a *de minimis* exception, however, the proposed regulations provide that if less than 5 percent of the total gross receipts derived by a taxpayer from a construction project are derived from activities other than the construction of real property in the United States (for example, from the sale of tangible personal property, or land) then the total gross receipts derived by the taxpayer from the project are domestic production gross receipts from construction.

The proposed regulations clarify (based on a 2005 amendment to section 199) that, to qualify for the section 199 deduction, the taxpayer performing the construction must be engaged in a construction trade or business on a regular and ongoing basis. The determination of whether an entity is in a construction business is generally made on an entity-by-entity basis. However, all members of an affiliated group as defined in section 1504(a) are treated as a single corporation; moreover, this rule applies to "expanded affiliated groups," defined in section 199(d)(4) by reducing the 80% ownership requirement to 50% for this purpose.

In addition, the taxpayer must actually perform the construction activity. For example, if a taxpayer in a construction business hired an unrelated general contractor to construct a building, the gross receipts derived by the taxpayer from the sale of the building would not be domestic production gross receipts because the taxpayer did not construct the building. For developers who do not operate in a corporate affiliated group, this means that, in general, the entity claiming the section 199 deduction must also be the contractor.

Under the proposed section 199 regulations, domestic production gross receipts derived from construction includes "the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer in the United States (whether or not the property is sold immediately after construction is completed and whether or not the construction project is complete)." Domestic production gross receipts derived from the construction of real property also includes compensation for the performance of construction services by the taxpayer in the United States.

Disposition of Land

Gross receipts attributable to the disposition of land are not eligible for the section 199 deduction. To address the administrative burden in identifying and valuing the gross receipts attributable to land in connection with qualifying construction activities, the proposed regulations provide a safe harbor (the "land safe harbor").

Under the land safe harbor, a taxpayer may allocate gross receipts between the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer and the gross receipts attributable to the sale, exchange, or other disposition of land by reducing its costs related to domestic production gross receipts by the cost of the land and any other costs capitalized to the land (including land costs in any common improvements), and by reducing its domestic production gross receipts from qualifying construction activities by those land costs plus a specified percentage of those costs. The percentage is based on the number of years that elapse between (i) the date the taxpayer acquires the land, including the date the taxpayer enters into the first option to acquire all or a portion of the land, and (ii) the date or dates on which the taxpayer sells the real property. The percentage is: 5 percent for years zero through 5; 10 percent for years 6 through 10; and 15 percent for years 11 through 15. Land held by a taxpayer for 16 or more years is not eligible for the land safe harbor and the taxpayer must actually allocate gross receipts between the land and the qualifying real property. For example, if a taxpayer acquires land in 2001 and constructs houses that it sells in 2005, 2008, and 2012, the domestic product gross receipts attributable to the houses sold in 2005 are subject to the 5 percent reduction; the receipts attributable to the houses sold in 2008 are subject to the 10 percent reduction; and the receipts attributable to the houses sold in 2012 are subject to the 15 percent reduction.

This safe harbor simplifies the application of section 199, and in some cases confers a substantial benefit on taxpayers. However, the clock for the holding period under the land safe harbor starts running when the taxpayer acquires the land or first holds an option to acquire the land. Since many developers warehouse land or hold options on land for extended periods of time, this feature of the safe harbor may undermine its utility in particular cases.

More fundamentally, since rents in the construction context are not qualified receipts and since the construction must actually be performed by the taxpayer, the benefits of section 199 are available only with respect to construction by contractors or developers who are their own contractors. Outside of this situation, real estate developers will only be able to reap the benefits of section 199 by negotiating with their contractors to capture some of the benefits derived by those who may benefit from the deduction.