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Dollars & Sense

IMPACT OF THE NEW MANUFACTURING TAX DEDUCTION

A new federal income tax deduction is available to "manufacturers" for tax years beginning in 2005. Fortunately for taxpayers, the IRS' definition of a manufacturer is quite broad. Many construction industry providers, for instance, qualify as "manufacturers" under the new law, including contractors, architects and engineers.

The new tax law allows for a tax deduction equal to three percent for the 2005 and 2006 tax year of a taxpayer's net income derived from activities that are considered "manufacturing", referred to as "Qualified Production Activities Income"(QPAI) by the IRS, subject to limitations. Increases to the new manufacturing tax deduction are scheduled to be phased in over the next few years, with the deductions scheduled to be as follows: six percent for taxable years beginning in 2007 to 2009 and nine percent starting in 2010. The deduction is limited to 50 percent of the W-2 wages paid by the taxpayer during the calendar year.

In order for construction industry activities to be considered QPAI, the construction of real property must take place in the United States. The taxpayer must be engaged in a trade or business that is considered construction under the North American Industry Classification System (NAICS) on a regular and ongoing basis. Construction, for purposes of the new manufacturing deduction, is defined as the building or substantial renovation of commercial and residential buildings, homes, their structural components, inherently permanent structures, land improvements and infrastructures. Tangible personal property purchased by a taxpayer (for example, appliances, furniture and fixtures) and sold as part of a construction project is not considered real property for this purpose. However, if more than 95 percent of the total gross receipts derived by a taxpayer from a construction project is attributable to real property, the total gross receipts are considered QPAI.

The IRS will allow more than one taxpayer to qualify for the deduction with respect to the same activity and the same construction project. However, taxpayers must actually perform the construction activity in order to get the deduction. For example, if the owner of land in the U.S. hires an unrelated general contractor to erect a building and the general contractor hires a subcontractor to work on the electrical system of the building, the amounts that the general contractor receives from the owner and the amounts that the subcontractor receives from the general contractor are considered QPAI. But the amount that the owner receives from the subsequent sale of the building does not qualify as QPAI, because the owner did not engage in an activity constituting construction.

If a taxpayer who engages in land development sells land, the individual will have to use a method to allocate the sales proceeds between proceeds attributable to the sale of the land, which is not QPAI, and proceeds attributable to land development activities, which would be considered QPAI. IRS Notice 2005-14, issued in January 2005 to help clarify the new law, lists the following examples of land development activities that qualify as QPAI: grading, landscaping and painting.

Gross receipts derived from architectural and engineering services that are related to real property construction, and are performed and located in the United States are considered QPAI, regardless of whether the construction project has begun or has been completed.

This can be a daunting task to understand, so we recommend you seek the advice and counsel of a professional accountant experienced in these areas.

References: Code Sec. 199, Notice 2005-14 and proposed regulation NPRM REG-105847-05

The purpose of this article is to provide general information. There are many other factors that may be unique to a specific taxpayer where the general information provided above may not apply. Therefore, we recommend that the information in this article not be relied or acted upon without consulting with your professional tax advisors.

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