



LEGAL NOTES

ABA – ARIZONA BUILDERS' ALLIANCE

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Vol. 17, #1

Congress Reduces 2005 Income Tax on Construction Income

January 2006

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Contractors will benefit from a reduction in federal income taxes on “production activities” starting this year. A new provision (called Section 199) allows a deduction equal to 3% of net income from these activities (increasing to 9% in future years). The deduction effectively reduces tax rates on income from construction—for example, the top tax rate will be reduced about one percentage point (from 35% to 34%) in 2005-2006; two percentage points in 2007 through 2009; and three percentage points in 2010 and after.

This new tax break was enacted last fall when Congress repealed the exclusion from tax of extraterritorial income, which was basically income from foreign sales of U.S. goods. The new deduction is much broader than the old exclusion. It reduces tax on income from U.S. “production activities,” which include not only manufacturing, but also construction, architecture and engineering for construction projects. In all cases, the income must be earned in the U.S., on U.S. construction projects.

Construction activities that qualify for the new deduction include construction or renovation of residential and commercial buildings, their structural components, and infrastructure. Land improvements (grading and landscaping, for example) and painting are construction activities only if performed in connection with construction of a building.

To qualify for the deduction, renovation must increase the value or useful life of the property, or adapt it to a different use; otherwise, the activity is repair, not construction.

Other Aspects of the New Deduction, as it Applies to Construction Activities

- Engineering and architectural services include not only design and drawings, but also consultation, supervision of construction, and feasibility studies. The deduction can be taken even if construction is not undertaken.
- The deduction for income from production activities is available for alternative minimum tax purposes as well as income tax purposes. For sole proprietors and owners of LLCs and partnerships, however, the deduction cannot be taken for self-employment tax purposes. The deduction is solely a means of reducing income tax and AMT rates.
- Income from construction activities refers to compensation for construction services and proceeds from the sale of property constructed by the taxpayer; it does not include rent received on constructed property.

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The law firm of Jennings, Strouss & Salmon prepared this issue of ABA Legal Notes. ABA Legal Notes is a regular publication provided to members by the Alliance's Legal Advisory Council. Upcoming issues will be written and edited by other council members. These articles are not intended to provide complete legal analysis of each subject covered. For specific questions, please contact a lawyer.

- An affiliated group of corporations is considered a single taxpayer. The sale of a building by a corporation to an affiliated corporation, therefore, will not result in a production activities deduction.
- Net income from the sale of land does not figure in the deduction, so contractors selling improved real property must reduce their net income by any gain from sale of the land before computing the 3% (or 6% or 9%) deduction. The proposed regulations contain a safe harbor that is a real benefit for Arizona contractors selling land as a part of a construction project: in allocating total purchase price to the land, the taxpayer can assume that the land has appreciated in value very modestly—5% if sold within 5 years of acquisition, 10% if sold after 6 to 10 years, and 15% if sold after 10 to 15 years. A contractor selling homes in 2005 built on land purchased in 1996 for \$10,000 an acre, for example, that spends another \$1,000 per acre on entitlements, would have to ascribe part of the sales price to the land at the rate of only \$11,100 per acre (110% of total cost), whatever the current value of a lot. There seems no reason that this same allocation must be used in computing state sales tax.
- If unimproved land is zoned and graded, and roads and sewers are built and then sold, only gross receipts derived from the construction of infrastructure are eligible for the deduction—according to the proposed regulations—not those from the land as graded, or the entitlements.
- The deduction cannot exceed one-half of W-2 wages paid by the taxpayer. This limitation could especially affect sole proprietors, LLCs, and partnerships, since compensation payments to the owners of these forms are not W-2 wages. If an LLC had no employees except its members, for example (perhaps because all outside services are provided by independent contractors), it would not qualify for this new tax deduction because it would pay no W-2 wages.
- Also, the new deduction cannot exceed overall taxable income (or adjusted gross income) of the taxpayer. For pass through entities, such as LLCs and partnerships, this restriction applies at the owner level.
- A taxpayer that engages in businesses in addition to construction or other production activities will have to allocate total expenses between the activities to determine net income from production activities. The IRS has complex rules for making such allocations.
- Activities must be performed by a business that is considered construction, engineering or architecture under the North American Industry Classification System (NAICS code).

This article is intended for general information purposes only and not as specific legal advice. You are urged to consult an attorney concerning your situation and any specific legal questions you may have.

If you have any questions or desire any further information, please contact the author of this article, Stephen E. Lee, at 602.262.5824 or slee@jsslaw.com.

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