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COMMERCIAL TAX ISSUES 2005

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New deduction benefits manufacturing and construction industries

Internal Revenue Code Section 199 allows a deduction of 9% (3% for years beginning in 2005 and 2006, and 6% for years beginning in 2007 – 2009) of the *lesser* of "qualified production activities income" (QPAI) or taxable income for the taxable year (determined without this deduction). The maximum amount allowed as a deduction is limited to 50% of W-2 wages for the taxable year. For this purpose, W-2 wages are generally equal to the adjusted wages reported in box #1 of Form W-2, plus elective deferrals such as those for 401(k) plans, etc.

QPAI is defined as the excess of "domestic production gross receipts" over the cost incurred to generate those receipts. In simpler terms, it is the net income derived from the manufacture, production or construction of domestic (made in the USA) products.

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The construction industry will benefit from the deduction if receipts are from construction activities performed on property that is deemed to be real estate. "Construction activities" include the *erection or substantial renovation* of real property. The term does not cover tangential services such as hauling trash and debris, and delivering materials unless conducted by the party performing the actual construction. Improving land, such as grading and landscaping, and painting will be deemed part of construction activities only if they are performed in connection with other activities that constitute the erection or substantial renovation of real property.

Construction performed in the USA has been defined to mean the construction of real property that is residential and commercial buildings and their structural components, inherently permanent structures *other than* tangible property in the nature of machinery, inherently permanent land improvements and *infrastructure* by a taxpayer who is considered to be in the trade or business of construction for purposes of the NAICS codes. Property that is tangible personal property is not subject to the deduction.

The term *infrastructure* for purposes of the definition of construction includes roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable and wiring.

Gross receipts from the sale of land are not considered to be income that is eligible for the deduction. In this situation, in order to compute the deduction, the land portion of the sale, together with its related costs, must be segregated from the total income.

The rules are complex, and may be calculated differently for different taxpayers. For an example, visit the TaxAlert section of the WS+B Web site at www.withum.com. Also, please do not hesitate to contact a WS+B professional at your local office and allow us to determine how the new deduction may benefit your organization.

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