The New IRC Section 199 Deduction

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Outline

- IRC Section 199 Overview
- Real Estate Specific Application, Examples, Issues
- Pass-thru Entities
- Other Details:
  - Individuals
  - Expanded Affiliated Groups
  - Wages
  - Allocation Methods

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Sec. 199 Overview

- See Overview Diagram/Handout
  - Created by American Jobs Creation Act of 2004
  - Replaced an allegedly illegal export tax benefit (10/22/04)
    - "Disguised rate reduction" to replace this export subsidy
  - Interim guidance issued in form of IRS Notice 2005-14 (1/19/05). Regs to follow.
  - AICPA Response to Notice

Sec. 199 Overview

- Sec. 199 tax deduction based on the <u>lesser</u> of a % (3% in 2005/06; 6% in 2007/08/09; 9% thereafter) of :

  - Qualified Production Activities Income (QPAI),

    OR

  - Taxable Income (TI) without taking this deduction into account.

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Sec. 199 Overview

- Limitation - capped at 50% of W-2 wages paid by the employer.

- Wages do not include amounts paid to
  - independent contractors or
  - partners.

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Qualified Production Activities Income

- Qualified Production Activities Income (QPAI) Equals
  - Domestic Production Gross Receipts (DPGR) less the sum of
    - Cost of Goods Sold allocable to DPGR
    - Other deductions, expenses, losses directly allocable to DPGR
    - A ratable portion of other deductions, expenses and losses not directly allocable to DPGR or another class of income
- See Handout Example

Domestic Production Gross Receipts

- Allocation of DPGR and non-DPGR
  - No single prescribed method
  - Allocation base must be reasonable/accurately reflective
  - Available information used by management
- IRS Notice Safe Harbor
  - If > 95% of gross receipts is DPGR, then can consider all gross receipts DPGR
  - Avoids cost allocations to non-DPGR

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Qualified Production Activities Income

- Cost allocations for QPAI should be generally consistent with 263(a)/Unicap allocations:
  - Past aggressive omission of 263(a) voids 199 deduction - by definition not a "producer"
  - Change in accounting method to correct past 263(a) problems?

- Handout - 3 example illustration

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Domestic Production Gross Receipts

- DPGR includes gross receipts derived from:
  - Lease, rental, license, sale, exchange, etc. of Qualified Production Property (QPP) manufactured, produced, grown, extracted (MPGE) in whole or significant part in the US, including
    - Qualified films
    - Electricity, natural gas, potable water produced in the US
  - Construction performed in the US by the taxpayer (as defined in NAICS codes. AICPA objects)
  - Engineering or architectural services performed in the US for construction projects in the US

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Architectural and Engineering (A&E) Services

- Gross receipts from A&E services are DPGR if:
  - Related to real property (AICPA wants to eliminate this requirement)
  - Performed in the US
  - For construction projects located in the US
  - And it does not matter if project is started or finished

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Domestic Production Gross Receipts

- Non-qualifying property - DPGR does not include receipts derived from:

  - Sale of food or beverages prepared at a retail establishment
  - Transmission or distribution of electricity, natural gas, potable water

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Qualified Production Activities Income

- QPAI is determined on an item by item basis according to IRS.
- AICPA Concern:
  - Too detailed
  - Too burdensome
  - What is an "item" (No definition)
  - Impractical

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Qualified Production Activities Income

- QPAI is determined on an item by item basis. AICPA Concern:
  - Notice 2005-14 occasionally implicitly uses a transaction by transaction approach instead of item by item
  - AICPA recommends safe harbor to exclude item by item determination of QPAI if >95% of gross receipts are DPGR

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Qualified Production Activities Income

- QPAI is determined on an item by item basis.

  AICPA Concern:

  Notice 2005-14 says you can use any reasonable method but MUST use specific ID method if info is available. Is this true?

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Real Estate Specific Application, Examples, Issues

Construction

- DPGR includes gross receipts derived from construction performed in the U.S.
  - includes "activities that directly relate to"
    - erection or substantial renovation of
    - residential and commercial buildings and infrastructure.

Construction Performed in the US

- Notice 2005-14 defines as erection or building of:
  - commercial and residential buildings and structural components
  - inherently permanent structure that is not tangible personal property
  - land improvements
  - infrastructure items

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Construction Performed in the US

- Notice 2005-14 defines as erection or building as including:
  - substantial renovations of real property.
  - hauling trash and debris or delivering materials if done in connection with a construction project.
  - land improvement activities like landscaping, grading and painting if done in connection with erection or substantial renovation of real property.

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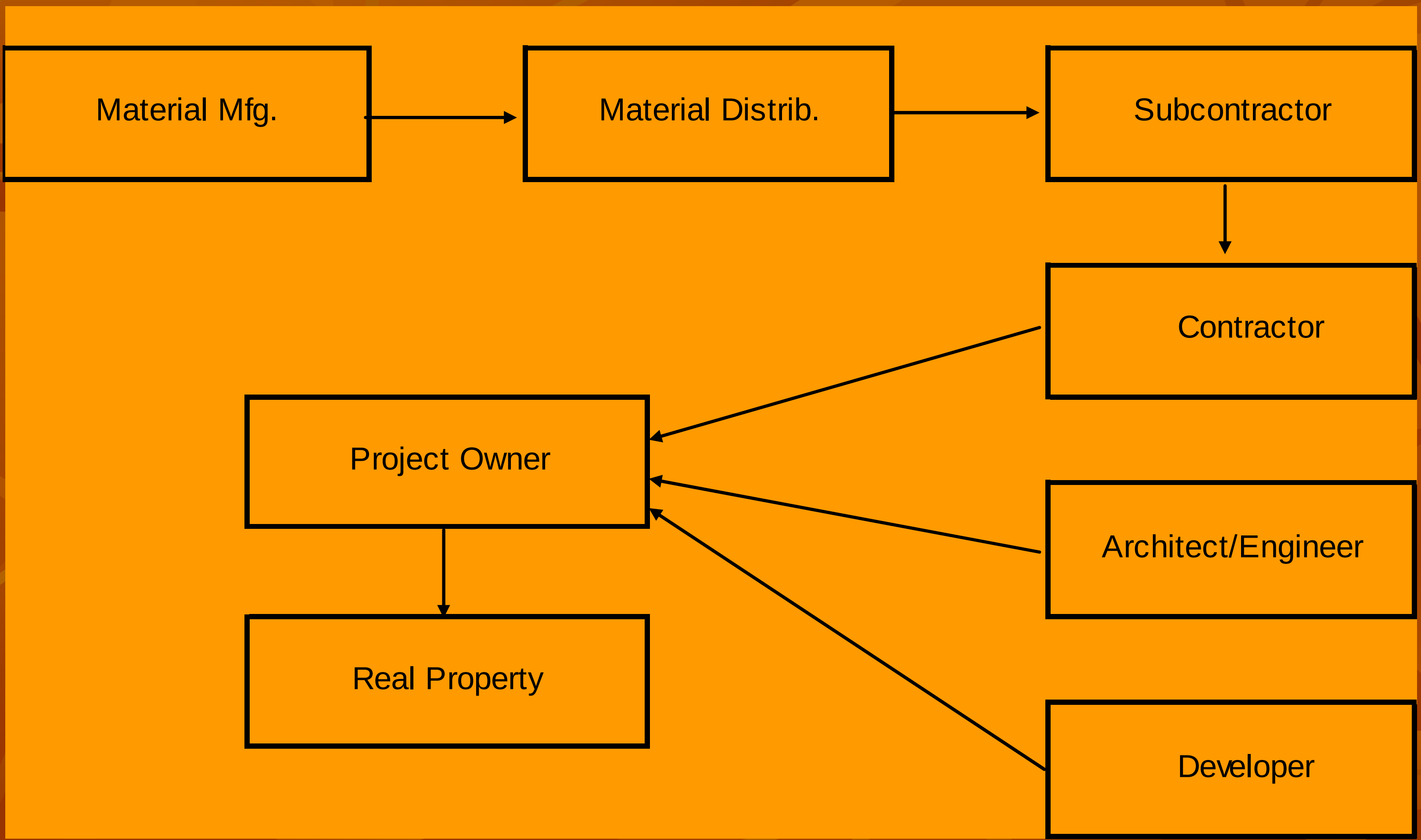
Construction Performed in the US

- DPGR/QPAI Does Not Include:
  - Rental income from real estate (AICPA disagrees), although DPGR does include proceeds on ultimate disposition but only if owner engaged in related construction activities
  - Land?
    - IRS Notice indicates sale of the underlying land in a real estate/construction project is not part of DPGR - value land before and after improvements but w/out regard to improvements?
    - AICPA disagrees - sees no difference made for any other production "raw material", so why for land. Not specifically excluded in statute or legislative history, only in the Notice.
    - Practical example - residential project/263(a) link?

Construction Performed in the US

- All gross receipts derived from a construction project are DPGR if > 95% of gross receipts are derived from real property.
- What if homebuilder sells a home and more than 5% of the gross receipts are from the sale of related personal property (window treatments, furnishings, etc)?
    - Those related gross receipts and costs are excluded from DPGR and QPAI calculations.
    - Land, even if excluded for QPAI, is still included in meeting this 95% real estate test.

General Example
Where is the QPAI?



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Example: Rental Real Estate

- Typically no DPGR, therefore no QPAI,
  - (unless AICPA gets “rental real estate” exception eliminated).
    - Typically there are tax losses from rental (depreciation), 50% TI limit hits and also voids salary pass through.
- Except possibly upon disposition of property
  - if rental entity participated in original construction activities or (maybe) a substantial renovation?
  - But, disposition of an interest in a real estate entity does not qualify.

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Example: Land Developer

- Preps land & sells lots to builder
- Usually profitable, so TI limit should not hit
- Split sales proceeds between sale of land (non-DPGR) and land development activities (should be DPGR)
- Subject to W-2 wages limit

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Example: Residential Developer & Builder

- Acquires land, preps, subdivides & builds
- Split sales proceeds between sale of land (non-DPGR) and development/building activities (largely DPGR)
- Watch out for personal property sold
- Subject to W-2 wages limit

Example: General Contractor

- All income likely DPGR/QPAI
- Subs out all construction work
- Does not own real estate
- Watch out for personal property sold as part of the contract
- Subject to W-2 wages limit

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Example: Sub-Contractor

- All income likely DPGR/QPAI
  - Unless engaged in significant maintenance/service call business (HVAC)
  - Segregate this to another entity?
- If utilizing employees, W-2 cap not problematic
- If engaging LLCs or utilizing 1099 helpers, W-2 cap could be problematic

Example: Fee Developer

- Gross receipts (fee income) seems to meet the "from activities directly related to construction" test, so DPGR/QPAI would exist,
- May have non-DPGR,
- Subject to W-2 wages limit,
- Usually profitable relative to TI limit
  - unless holding interests in loss generating rental real estate pass-thrus

Pass-thru Entities

Pass-thru Entities

- Apply Sec. 199 at the shareholder/partner level. Shareholder/Partner is allocated share of:
  - QPAI (not the 199 deduction), and
  - W-2 wages from the entity in amount equal to <u>lesser</u> of:
    - Shareholder/Partner's allocable share of wages, or
    - 2 times applicable % of the QPAI allocated to Shareholder partner.
- Note: Notice precludes partner from taking into account W-2 wages of partnership if QPAI allocated to partner is < or = Zero.

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Pass-thru Entities

- AICPA: Guidance needed in tiered partnership structure:
  - 2nd tier partnership +QPAI and W-2 wages
  - 1st tier partnership –QPAI (W-2 wages should flow despite –QPAI of 1st tier partnership)

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Other Details

Other Rules

- For individuals, AGI is substituted for TI for 50% TI limitation.
- Expanded Affiliated Group ("EAG" generally 50% control) - members are treated as a single entity.
  - The aggregate deduction is allocated among the EAG members in proportion to their QPAI.
- AMT - Sec. 199 deduction allowed for AMT purposes (percentage of QPAI vs. AMTI)

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W-2 Wages

- 50% of wages paid to taxpayer's current or former employees shown on W-2 for <u>calendar year</u> ending during the tax year.
- Employees include corporate officers and common law employees.
- Wages of common paymaster may be taken into account.

W-2 Wages

- Wages are wages paid for withholding tax purposes plus certain elective deferrals for retirement contributions and salary reduction arrangements.
- No single box on W-2 satisfies this definition
- So, there are 3 methods:
  - The unmodified box method
  - The modified box one method
  - The tracking wages method

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W-2 Wages

- Unmodified Box Method:
  - Total amounts for wages in box one or box five (Medicare) of the W-2.
- Modified Box One Method:
  - Total Box one, subtract amounts that are not wages for purposes of FIT withholding and also Code Sec. 3402(o) annuities, supp. Unemployment, and sick pay not constituting wages, then add Box 12 amounts coded D, E, F, G, or S.
- Tracking Wages Method:
  - Total wages subject to FIT withholding
  - Subtract supp unemp. Comp. benefits
  - Add Box 12 amounts coded D, E, F, G, or S.
  - Required for short tax year

Subpart F: Reg. Sec. 1.861-8

- Computation of taxable income from sources within the US and from other sources and activities:

Cost and Deduction Allocation

- Cost and deduction allocations to DPGR in computing QPAI are done in one of 3 ways:
  - Sec. 861 Method. This is a very detailed method that requires you to identify classes of gross income that deductions are definitely related to, apportioning deductions among those classes, and then allocating deductions within each class of income between statutory grouping and residual grouping.

NB: COGS allocable to DPGR includes costs that would have been included in ending inventory under 263A. IRS wants taxpayers to compute COGS allocable to DPGR by identifying deducted costs that would have been included in COGS if the amount had been directly computed for any other federal tax purpose.

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Cost and Deduction Allocation

- AICPA Concern: Sec. 861, while reasonable, is burdensome; it's an entirely new scheme for taxpayers with 100% domestic production. The simplified methods can reduce burden for taxpayers who don't presently qualify for a simplified method.
- AICPA Proposal: If >90% of costs are related to DPGR, then 100% of the costs should be allocated to DPGR.

Cost and Deduction Allocation

- Simplified Deduction Method. A taxpayer with average annual gross receipts of $25 million or less may allocate its deductions, other than COGS, between DPGR and other receipts based on relative gross receipts.

  AICPA Proposal: All taxpayers should be eligible for this method.

- Small Business Simplified Overall Method. A taxpayer with average annual gross receipts of $5 million or less for three years preceding the current year, or one eligible to use the cash method of accounting, can elect this method. This allows both COGS and other deductions to be apportioned between DPGR and other receipts based on relative gross receipts.

IRC Section 199 Conclusions for Real Estate

- A good incentive/“Freebie”.
- Scales up to 9% over time.
- Complicated/subject to final Regs:
  - DPGR and cost allocations for QPAI
  - Fiscal year taxpayers (calendar year wages)
  - Pass-thru’s
  - Expanded Affiliated Groups - identification, aggregation, computations, re-allocations

IRC Section 199 Conclusions for Real Estate

- Plan early, prior to year end and tax time to
  - identify issues and opportunities,
  - establish methodologies,
  - aid in year end tax planning.

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