CFMA Building Profits
THE MAGAZINE FOR CONSTRUCTION FINANCIAL PROFESSIONALS

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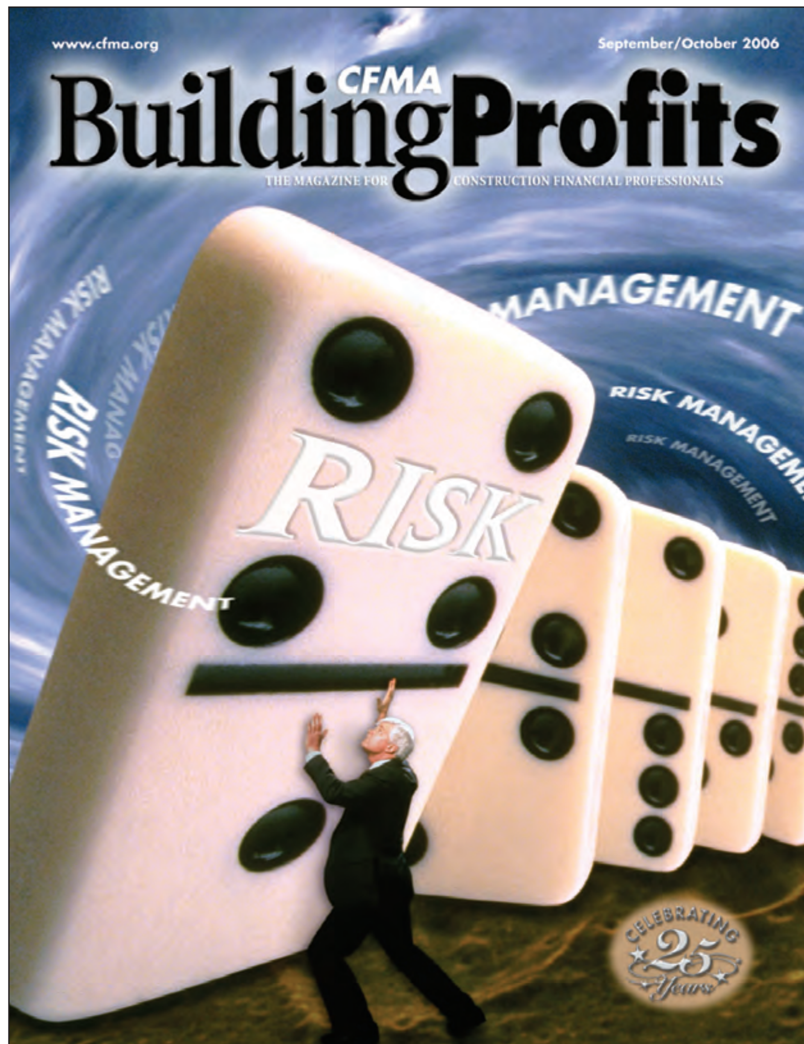

SEPTEMBER-OCTOBER 2006

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION
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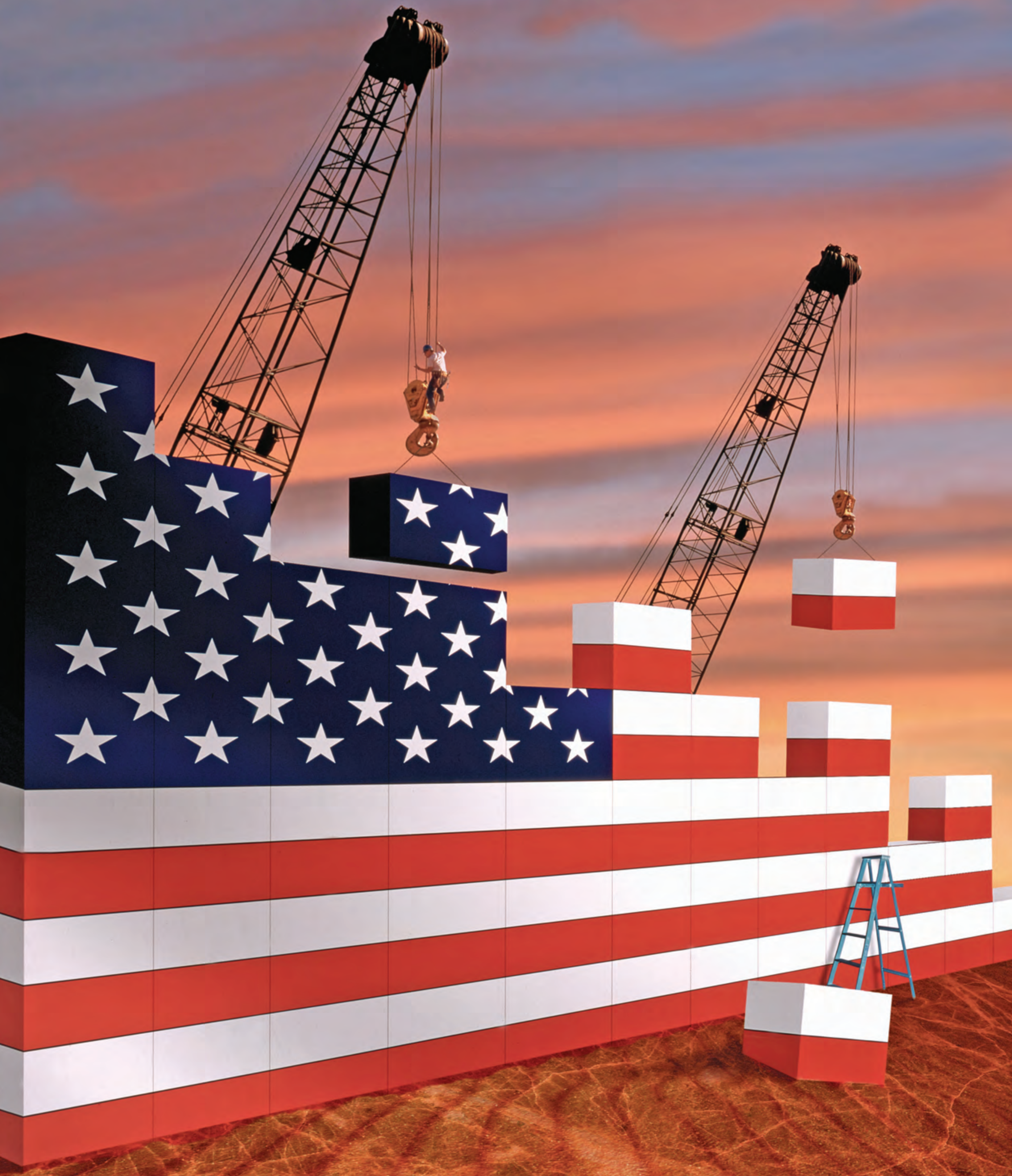
A CFMA SPECIAL REPORT:



DPAD Regulations Finalized, Part 1

BY RICHARD R. SHAVELL

In May 2006, the IRS issued final regulations under IRC §199, Domestic Production Activities Deduction (DPAD).[1]

As a result of comments submitted by CFMA, as well as other industry stakeholders, the final regulations reveal significant changes from prior guidance and liberalize certain important rules.

A CFMA SPECIAL REPORT

The basic structure of the DPAD is relatively unchanged from the original deduction introduced in the *American Jobs Creation Act of 2004 (Pub. L. No. 108-357).* As before, the DPAD can lower a contractor's tax burden, expanding profits and increasing cash flow.

For those who qualify, the deduction starts at a transition percentage of 3% for 2005 and 2006, increases to 6% for 2007 through 2009, and peaks at 9% in 2010.[2] Eventually, the deduction will reduce the impact of corporate income tax for qualifying activities by approximately 3%.

(For a more thorough description of the original legislation and early guidance, see "Reporting the Domestic Production Activities Deduction" by George Parrott in the July/August 2005 issue.)

This article, the first of a two-part special report, focuses on the final regs and their impact on contractors. It includes a brief overview and a discussion of specific issues that face contractors, developers, and homebuilders, as well as architects and engineers.

Overview

Businesses may claim a DPAD that is equal to a percentage of the income earned from specific production activities undertaken in the U.S. This includes construction, engineering, and architectural services, as well as several other industries.[3] Part of the reason

for the new deduction is to encourage domestic production and to increase domestic jobs. The DPAD equals the lesser of two amounts for the tax year:

1) A percentage (3%, 6%, or 9%) of the smaller of:
- the Qualified Production Activities Income (QPAI) of the taxpayer or
- taxable income

2) 50% of the employer's W-2 wages.[4]

Let's assume that ABC Construction Co., has the following results for the year 2010, which allows the full 9% reduction:

- Gross receipts of $10 million, 100% of which qualify as Domestic Production Gross Receipts (DPGR)
- A QPAI of $1 million
- Taxable income of $1.1 million
- W-2 wages of $900,000

Here's how to determine the DPAD. First, multiply the QPAI of $1 million by the statutory rate of 9% for a potential deduction of $90,000. Then, compare the potential deduction of $90,000 to taxable income of $1.1 million. The $90,000 is smaller, so it supercedes the taxable income as the potential deduction.

Next, multiply the employer's W-2 wages of $900,000 by 50%. Last, compare the $90,000 to the W-2 limitation amount of $450,000. Because the $90,000 potential deduction is smaller than the result of the W-2 limitation amount, it is the DPAD. Exhibit 1 shows these calculations in detail.

Notice how important the wage computation is to ensure the maximum deduction. If your company does not have sufficient wages, then the DPAD may be eliminated. Likewise, if there is no QPAI, then the DPAD will be reduced.

Note: The examples in the rest of this article closely mirror those in the final regs. An endnote at the end of each example references the corresponding language.

Exhibit 1: Sample DPAD Calculation

ABC Construction Co., Inc.
Domestic Production
Activities Deduction, 2010

Total Gross Receipts from All Activities		$10,000,000
Gross Receipts Not Domestic Production Gross Receipts		0
Domestic Production Gross Receipts (DPGR)		**$10,000,000**
Less:		
Cost of Goods Sold (CGS) Directly Attributable to DPGR		0
Direct Expenses Attributable to DPGR		8,800,000
Indirect Expenses	$200,000	
Allocation %	100%	
Allocable Portion of Indirect Expenses Attributable to DPGR		200,000
Qualified Domestic Production Activity Income (QPAI)		**$1,000,000**
Taxable Income (AGI for Individuals)		1,100,000
Smaller of Taxable Income or QPAI		1,000,000
Applicable Percentage for the Year		9%
Deduction Based on Current Year Percentage		90,000
W-2 Wages		900,000
Limitation at 50%		450,000
QPAD (Smaller of Deduction or Wage Limitation)		**$90,000**

This sample is based on an overview of DPAD.
Always consult with your tax advisor before implementing computations.

General Requirements for Contractors

To be entitled to a DPAD for construction work, your company must:

1) Be engaged in the active conduct of a trade or business treated as a construction activity,

2) Perform construction work involving real property in the U.S., and

3) Derive DPGR from the construction activity.

On the surface, these three requirements seem simple; however, the details are more complex.

Requirement 1: Be Engaged in Construction Activity

To qualify for the DPAD as a construction company, the regs stipulate that the business must qualify as a contractor under the North American Industry Classification System (NAICS).

Under NAICS, construction is a six-digit code starting with 23. However, there are exceptions; for example, a business with an NAICS code of 213111 (drilling oil and gas wells) also qualifies.[5]

The proposed regs required "regular and ongoing" construction activities; the final regs

As before, the **DPAD** can LOWER a contractor's TAX BURDEN, **EXPANDING PROFITS** and INCREASING CASH FLOW.

adjusted this requirement to address concerns that certain entities established to develop only one project might be disqualified. Under two safe harbors, an entity may qualify if the taxpayer:

1) Sells or exchanges the constructed real property within 60 months of the date when construction is completed, or

2) Is a newly formed entity in its first tax year, and the taxpayer reasonably expects to be engaged in a trade or business on a regular or ongoing basis.[6]

For example, ABC Construction and Development Co., Inc., a commercial contractor and developer under NAICS code 236220, purchases a building and hires EFG Construction Co., Inc., an unrelated entity, to oversee a substantial renovation of the building.

Although not licensed as a GC, EFG performs activities relating to management and oversight of the construction process, such as approvals, periodic inspection of the project's progress, and required job modifications.

EFG retains HIJ General Contractors, Inc., to oversee day-to-day operations and award the subcontracts. HIJ hires KLM Electrical to install a new electrical system in the building as part of that substantial renovation.

Which activities qualify as producing DPGR in this scenario? Provided EFG Construction Co., Inc., HIJ General Contractors, Inc., and KLM Electrical meet the other requirements of the regs, three amounts qualify for construction services:

1) The amount that ABC pays EFG for GC level work,

2) The amount that EFG pays HIJ to oversee the day-to-day operations, and

3) The amount that HIJ pays KLM for electrical work.

Interestingly, the gross receipts that ABC receives from the subsequent sale of the building do not qualify as DPGR. Even though ABC is in the trade or business of construction, it did not engage in any activity constituting construction under the regs.[7]

Requirement 2: Perform Construction Work Involving Real Property

Substantial Renovation

Construction activities must involve real property to qualify for the DPAD. Tangible personal property (such as furniture and fixtures, appliances, and other equipment sold as part of a construction project) is not considered real property.

Local law is not controlling for the definition of real property under the regs. The final regs attempt to clarify that the structural components of a building (i.e., an inherently permanent structure) include: "walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property."[8]

The regs clearly indicate that only a substantial renovation or erection of a structure qualifies for the deduction.[9] According to the regs, a substantial renovation is "the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or adapts the property to a new or different use."[10]

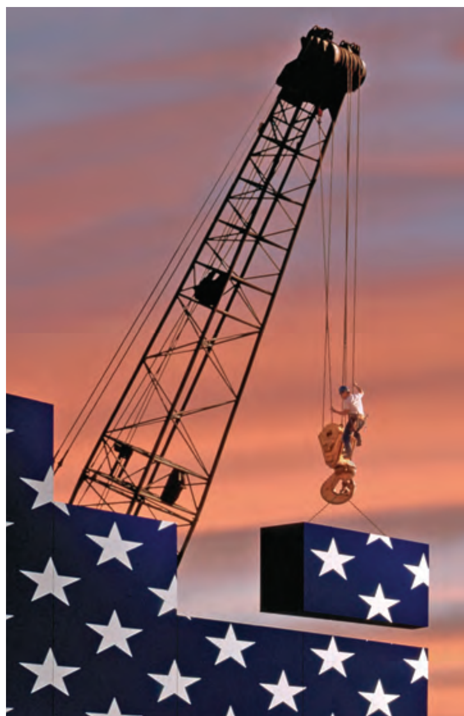
A simplistic view would be that a substantial renovation is a project for which the owner would capitalize the value of the construction upon completion. This presents an interesting situation for contractors who perform construction services, but don't know if the services performed constitute a substantial renovation.

What if the contractor believes its services constitute a repair, but the owner views the work as a permanent improvement? For example, an electrical subcontractor is hired to modestly increase the electrical service supplied to an industrial facility. This relatively minor work is needed

for the facility to provide power for a small, underutilized portion of the facility.

The electrical contractor may be unaware of planned leasehold improvements to the facility, and may simply consider the services a repair or possibly maintenance, even though these same services are integral to subsequent capital improvements performed at the site and are possibly eligible for the DPAD.

In addition, certain services (such as grading, demolition, and excavating) only constitute construction if they are performed in connection with other activities that constitute erection or substantial rehabilitation of real property.[11]



Under the regs, a taxpayer engaged in these services must make a reasonable inquiry or reasonable determination whether the services relate to the erection or substantial renovation of real property in the U.S.[12]

This issue was raised in comments to the Treasury about the proposed regs. Unfortunately, contractors may be forced to make a decision about a "substantial renovation" without having complete information.

Tangible vs. Real Property

For many years, the definition of tangible personal property for federal tax purposes has been controversial. With the advent of cost segregation studies, this may become an area of additional tax controversy. One interesting issue is how a contractor would construe certain activities as compared to the owner.

For example, consider a clean room facility. Depending on the interpretation of real vs. tangible personal property, there could be a significant amount of property the owner considers tangible personal property, not real property, for depreciation purposes.

At the same time, the contractor may presume that he is producing real property because of the services provided. This definition could have a significant impact if the IRS were to insist that the owner and the construction services provider treat all property consistently.

***De Minimis* Exception**

The regs have a *de minimis* exception that eases certain computations. If less than 5% of a taxpayer's total gross receipts result from activities other than the construction of real property in the U. S., then the total gross receipts derived from the project may be treated as DPGR from construction.[13]

For most contractors and subcontractors with homogeneous services working solely within the U.S., this means that 100% of their gross receipts will likely qualify as DPGR. The *de minimis* exception could also impact sellers of real property.

***De Minimis* Example**

ABC Development, Inc., is a U.S. builder under NAICS code 236220 engaged in the business of construction on a regular and ongoing basis. ABC purchases land and builds a hotel on it. Another company, XYZ Land Inc., enters into a contract with ABC to purchase the hotel.

As part of the contract, ABC furnishes the hotel with beds, bureaus, desks, chairs, and lamps. Upon completion of the sale of the building, ABC accounts for the land under the regulation's land safe harbor. After application of the land safe harbor, ABC uses the *de minimis* exception to determine if the gross receipts from the sale of the beds, bureaus, desks, chairs, and lamps qualify as DPGR.

If the gross receipts from the sale of the beds, bureaus, desks, chairs, and lamps are less than 5% of the total gross receipts derived by ABC from the sale of the furnished hotel, excluding any gross receipts taken into account under the land safe harbor, then 100% of the gross receipts derived from the sale of the furnished hotel may be treated as DPGR.[14]

Infrastructure

Infrastructure is considered real property under the regs. So what is considered infrastructure? Under the final regs, infrastructure includes: roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, wiring, and inherently permanent oil and gas platforms.[15]

Requirement 3: Derive DPGR from Construction Activity

Tangential Services

Certain activities may appear to be tangential to construction activities. However, they are not part of DPGR computations unless the tangential services are essential for construction undertaken by the contractor.

If the contractor also performs construction in connection with the construction project, then the gross receipts from tangential services, such as delivering materials to the construction site and removing construction debris, would be considered DPGR. If the taxpayer hauls or delivers materials without performing other construction activities, then the services do not qualify as tangential.[16]

The regs state that improvements to land that cannot be capitalized to the land (such as landscaping and painting services) are activities constituting construction only if the activities are performed in connection with other services that constitute the erection or substantial renovation of real property.[17]

The regs also address administrative support services, such as billing and secretarial functions, that are incidental and necessary to the construction project. If the taxpayer performs these administrative support services as part of construction activities, then the gross receipts allocable to these activities qualify for determining DPGR.[18]

Real Property Sales

If all the other requirements are met, the DPGR derived from the construction of real property includes the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer in the U.S.

This is the case whether or not the property is sold immediately after construction is completed, or whether or not the project is ever completed.[19] Developers who serve as GCs will likely experience significant benefits under the regs if they are structured properly to take advantage of the DPAD.

Materials

DPGR includes compensation for performance of construction services and gross receipts from materials and supplies consumed in the construction project, or that become part of the constructed real property.[20]

This is very important because it reverses a prior position in the proposed regs. Under the proposed regs, DPGR from the construction of real property did not include gross receipts from materials and supplies consumed in the construction project or that had become part of the constructed project.

Without this reversal, due in part to comments from CFMA and other industry organizations, many contractors would have had to allocate their gross receipts between their potentially DPGR-eligible construction activity and the cost of materials to complete the job. Of course, this would have resulted in a significant administrative burden and diminished tax savings.

Materials Example

ABC Construction, Inc., is engaged as an electrical contractor under NAICS code 238210 on a regular and ongoing basis. ABC purchases the wires, conduits, and other electrical materials that it installs in construction projects in the U.S.

In a particular construction project, all of the wires, conduits, and other electrical materials installed by ABC for the operation of that building are considered structural components of the building. ABC's gross receipts from installing that property are from the construction of real property.

In addition, pursuant to the final regs, ABC's gross receipts from the purchased materials qualify as DPGR because the wires, conduits, and other electrical materials are consumed during the construction of the building or become structural components of the building.[21]

Warranties

DPGR includes gross receipts from any qualified construction warranty provided in connection with the constructed real property. This is the case if, "in the normal course of the taxpayer's business:

- The price for the construction warranty is not separately stated from the amount charged for the constructed real property; and

- The construction warranty is neither separately offered by the taxpayer nor separately bargained for with the customers…"[22]

This means that the customer cannot purchase the construction services without also purchasing the construction warranty.

GC Services Clarified

The proposed regs did not specifically mention GC work as a construction activity. However, many commentators presumed that GCs could take the deduction based on one of the examples in the proposed regs. The example seemed to imply that a contractor had to be licensed as a GC to be treated as performing a construction activity.

The final regs clarify that activities relating to the management and oversight of the construction process (including approvals, periodic inspection of the project's progress, and required job modifications) qualify as DPGR from construction activities.[23]

Developers, Architects & Engineers

In addition to changes to the final regs and the three basic DPAD requirements, there are many other topics to consider, including issues affecting contractors who also serve as developers and who provide architectural and engineering services.

The Land Safe Harbor

The proposed regs, as well as IRS Notice 2005-14, 2005-7 I.R.B. 498, addressed where a taxpayer constructed real property and how the DPAD applied to the constructed real property. This issue received significant attention from the real estate and construction communities and generated a significant number of comments.

DPGR does not result in and of itself from the sale of land. If a qualifying taxpayer sells a built structure and the underlying land, the taxpayer must allocate gross receipts between the proceeds of the sale of the real property constructed (which qualifies as DPGR) and the gross receipts attributable to the underlying land (which do not qualify). The allocation can be done through an appraisal or by the safe harbor formula.

Under the safe harbor formula for allocation, the taxpayer must reduce the DPGR by the cost of the land and any other costs capitalized to the land, except for such activities as grading, demolition, clearing, excavating, and other activities that physically transform the land.[24] A percentage of the land costs must further reduce DPGR to represent the unknown increase in value of the land, possibly as a result of the improvements.

There are three general amounts representing land values that are excluded from DPGR on the sale of real property:

1) The raw land cost,

2) Capitalized land development/entitlement costs (does not include infrastructure or costs that transform the land), and

3) A safe harbor percentage multiplied by the combination of the first two amounts.

Safe Harbor Example

ABC Development and Construction Co., Inc., a builder under NAICS code 236117, buys unimproved land in the U.S., gets the land zoned for residential housing through an entitlement process, and grades the land. ABC also constructs roads, sewers, and sidewalks on the land, and installs power and water lines.

Next, ABC conveys the roads, sewers, sidewalks, and power and water lines to the local government and utilities. Then, ABC sells the land to homebuilders who construct houses on the land. What activities qualify as DPGR?

- ABC's gross receipts from the sale of the land attributable to the grading qualify as DPGR under the regs because those services are undertaken in connection with a construction project in the U.S.

- The gross receipts that ABC derives from the sale of lots attributable to grading – and the construction of the roads, sewers, sidewalks, and power and water lines that qualify as infrastructure under the regs – are also DPGR.

ABC's gross receipts from the land, including the capitalized costs of entitlements, do not qualify as DPGR because they are not from the construction of real property.[25]

Safe Harbor Reduction

The safe harbor percentage reduction is based on the number of months between the date the taxpayer acquires the land and ends on the date the taxpayer sells each item of real property on the land.[26]

This timeframe does not include any options to acquire the land. However, a special rule may apply to an option agreement so that the date the taxpayer acquired the land will include the time of the option agreement – but, only if the purchase price of the land on the option agreement does not approximate the fair market value of the land.[27]

When determining the percentage of a disposition of land between related parties for less than fair market value, the purchaser or transferee of the land must include the months during which the seller or transferor held the land.[28] The safe harbor percentages are:

- 5% for land that is held 60 months or less,
- 10% for land held more than 60 months, but not more than 120 months, and
- 15% for land held for 120 months, but not more than 180 months.

If the land is held for more than 180 months, it is not eligible for the land safe harbor and presumably an appraisal would be needed to determine the allocation for land.[29]

Safe Harbor Reduction Example

ABC Development and Construction Co., Inc., a contractor under NAICS code 236117, constructs housing that is real property. On June 1, 2007, ABC pays $50 million and acquires 1,000 acres for a new housing development. In November 2007, after spending $10 million for entitlement costs, ABC receives permits to begin construction. After this expenditure, ABC's land costs total $60 million.

The development consists of 1,000 houses to be built on half-acre lots over five years. Construction costs for each house are $170,000. ABC is contractually obligated or required by law to provide common improvements (streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools) at a cost of $55,000 per lot. These improvements of $55,000 per lot include $30,000 in land costs allocated to the common improvements.

On January 31, 2012, the first house is sold for $300,000. Pursuant to the land safe harbor, ABC calculates total costs of $255,000:

- $170,000 in construction costs
- Plus $30,000 in land costs for the lot
- Plus $55,000 in common improvements, including $30,000 in land costs

When the total costs are reduced by total land costs of $60,000, the basis for each house sold is $195,000. ABC calculates the DPGR for each house sold by taking the gross receipts of $300,000 and reducing that amount by land costs of $60,000, plus a percentage of $60,000.

Because ABC acquired the land on June 1, 2007, for each house sold on the land between January 31, 2012 and June 1, 2012, the percentage reduction for ABC is 5%. (ABC held the land for not more than 60 months from the date of acquisition.) So, with a cost of $195,000 for each house, ABC's DPGR for each house is $237,000:

- $300,000 in gross receipts
- Minus $60,000 in land costs

Exhibit 2: Safe Harbor Example 1

	Totals	Per Home
Purchase Price	$50,000,000	
1,000 Acres		
Date Acquired: Jun. 1, 2007		
Development Costs	10,000,000	
1,000 Homes Approved, Begin Construction: Nov. 1, 2007		
Land Costs – Raw Land	30,000,000	30,000
Common Improvements – Land Allocated	30,000,000	30,000
Common Improvements – Hard Costs	25,000,000	25,000
Construction Costs	170,000,000	170,000
Total Costs	**$255,000,000**	**$255,000**
DPGR Computation: Sales Within 60 Months		
Proceeds from Sale		300,000
Land Costs – Raw Land		(30,000)
Common Improvements – Land Allocated		(30,000)
5% Applicable Percentage of Land Costs		(3,000)
DPGR for Homes Sold Within 60 Months		**$237,000**
DPGR Computation: >60 & <120		
Proceeds from Sale		300,000
Land Costs – Raw Land		(30,000)
Common Improvements – Land Allocated		(30,000)
10% Applicable Percentage of Land Costs		(6,000)
DPGR for Homes Sold Between 60 & 120 Months		**$234,000**

This sample is based on an overview of DPAD.
Always consult with your tax advisor before implementing computations.

- Minus the $3,000 safe harbor percentage (5% of $60,000)

For each house sold on the land between June 2, 2012 and June 1, 2017, the reduction is 10%. (ABC held the land for more than 60 months, but not more than 120 months from the date of acquisition.) The cost for each house remains $195,000; but, of the $300,000 gross receipts, ABC's DPGR for each house is $234,000:

- $300,000 in gross receipts
- Minus $60,000 in land costs
- Minus the $6,000 safe harbor percentage (10% of $60,000)[30]

Exhibit 2 on the previous page shows these calculations in detail.

Another Safe Harbor Reduction Example

What happens to the calculations if ABC sold the entitled land after it received the permits to begin construction? Let's assume the sale takes place on December 31, 2007 to EFG Homes, Inc., an unrelated corporation, for $75 million. EFG is also engaged in the construction business on a regular and ongoing basis.

EFG incurred the costs of construction and common improvements, and then sold the houses. Because ABC did not perform any construction activities, none of ABC's $75 million in gross receipts derived from EFG are DPGR and none of ABC's costs are allocable to DPGR.

Pursuant to the land safe harbor, EFG calculates total costs of $270,000:

- $170,000 in construction costs
- Plus $37,500 in land costs for the lot
- Plus $62,500 in common improvements, including $37,500 in land costs

When the total costs are reduced by total land costs of $75,000, the basis for each house sold is $195,000. EFG calculates the DPGR for each house sold by taking the gross receipts of $300,000 and reducing that amount by land costs of $75,000, plus a percentage of $75,000.

Between January 31, 2012 and December 31, 2012, the percentage reduction for EFG is 5%. (EFG held the land for not more than 60 months from the date of acquisition.) So, of the $300,000 gross receipts, the DPGR for each house is $221,250:

- $300,000 in gross receipts
- Minus $75,000 in land costs
- Minus the $3,750 safe harbor percentage (5% of $75,000)

For the houses sold on the land between January 1, 2013 and December 31, 2017, the percentage reduction for EFG is 10% because EFG held the land for more than 60 months, but not more than 120 months from the date of acquisition. So, of the $300,000 gross receipts, the DPGR for each house is $217,500:

- $300,000 in gross receipts
- Minus $75,000 in land costs
- Minus the $7,500 safe harbor percentage (10% of $75,000)[31]

See Exhibit 3 on the next page for more information on these calculations.

The safe harbor rule helps many homebuilders and developers who would otherwise need an appraisal when they sell improved real estate in order to correctly allocate the proceeds between the land and the structure being sold. In essence, the safe harbor percentage simplifies determining the increased value of the underlying land, and should help mitigate an area ripe for tax controversy.

In many markets, the safe harbor determination of increased value is likely to be much less than the actual increased value attributable to the sale of the underlying land if appraisals were used. And, in many instances, the safe harbor will increase the taxpayer's DPAD because the lower the amounts allocated to the land on the sale of improved real estate, then the higher the DPGR that qualifies for the deduction.

Interestingly, the proposed regs were based on a calculation of years rather than months. Measuring by months causes a disadvantage to a taxpayer who holds land for more than 15 years, but less than 16 years. In this unique case, the taxpayer does not qualify for the safe harbor under the final regs.

Engineering & Architectural Services

DPGR does include gross receipts derived from engineering or architectural services for construction performed in the U.S. While taxpayers must be engaged in an engineering or

architectural services trade or business, it does not need to be its only (or primary) trade or business for purposes of NAICS.

This inclusion of engineering or architectural activities under the DPAD is helpful for design-build contractors. The NAICS codes are 541330 for engineering services and 541310 for architectural services. Just like contractors, the engineering or architectural trade or business must be operated on a regular and ongoing basis.[32]

The regs provide two safe harbors for qualification. In the case of a newly formed trade or business or a taxpayer in its first taxable year, a taxpayer is considered to meet these requirements if it reasonably expects to engage in the trade or business on a regular and ongoing basis. The DPGR includes gross receipts derived from engineering or architectural services, including feasibility studies for construction in the U. S. – even if the planned project is not undertaken or completed.[33]

The final regs define engineering services as "professional services requiring engineering education, training, and experience and the application of special knowledge of the mathematical, physical, or engineering sciences to those professional services such as consultation, investigation, evaluation, planning, design, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project."[34]

Architectural services are "the offering or furnishing of any professional services such as consultation, planning, aesthetic and structural design, drawings and specifications, or responsible supervision of construction (for the purpose of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project."[35] Such post-construction services as annual audits and inspections are not considered engineering or architectural services.[36]

Similar to construction services, there is a *de minimis* exception. This exception states that if less than 5% of the total gross receipts by the engineer, or architectural service provider, are derived from services not relating to a qualified construction project, then the 5% can be ignored. For example, there may be *de minimis* engineering or architectural services performed outside the U.S., but 100% of the gross receipts may be treated as DPGR for services performed in the U.S. on construction projects.[37]

Other Issues

This article covers several issues that specifically impact the construction industry. However, there are additional issues that contractors and other taxpayers need to address when computing their annual DPAD:

- Qualifying wages
- 50% wage limitation computations

Exhibit 3: Safe Harbor Example 2

	Totals	Per Home
Purchase Price	$50,000,000	
1,000 Acres		
Date Acquired: Jun. 1, 2007		
Development Costs	10,000,000	
1,000 Homes Approved		
Sale from ABC to EFG: Dec. 31, 2007	75,000,000	
ABC's DPGR – No Construction Performed	0	
Acquisition by EFG from ABC: Dec. 31, 2007	75,000,000	
Land Costs – Raw Land	37,500,000	37,500
Common Improvements – Land Allocated	37,500,000	37,500
Common Improvements – Hard Costs	25,000,000	25,000
Construction Costs	170,000,000	170,000
Total Costs	**$270,000,000**	**$270,000**
DPGR Computation: Sales Within 60 Months		
Proceeds from Sale		300,000
Land Costs – Raw Land		(37,500)
Common Improvements – Land Allocated		(37,500)
5% Applicable Percentage of Land Costs		(3,750)
DPGR for Homes Sold Within 60 Months		**$221,250**
DPGR Computation: >60 & <120		
Proceeds from Sale		300,000
Land Costs – Raw Land		(37,500)
Common Improvements – Land Allocated		(37,500)
10% Applicable Percentage of Land Costs		(7,500)
DPGR for Homes Sold Between 60 & 120 Months		**$217,500**

This sample is based on an overview of DPAD.
Always consult with your tax advisor before implementing computations.

- Cost allocations
- Related party structures and such issues as expanded affiliated groups (EAGs) and consolidated groups
- Pass-through entities
- Filing and reporting requirements

The second installment of this article will address some of these additional topics. In the meantime, CFMs should consult and work closely with their tax advisors to maximize the annual impact of the DPAD. For many contractors, this deduction will significantly decrease their tax burden and add profits directly to the bottom line. BP

RICHARD R. SHAVELL, CPA, CCIFP, is President of Shavell & Company, P.A., CPAs and Consultants, in Boca Raton, and Stuart, FL.

Rich has presented comments before the IRS on proposed regulations and has testified before the House and Senate on the business impact of proposed legislation.

A member of CFMA's South Florida Chapter, he is Vice Chair of the Tax and Legislative Affairs Committee, a trustee of the Institute of Certified Construction Industry Financial Professionals (ICCIFP), as well as Chair of ABC's National Tax Advisory Group.

Phone: 561-997-7242
E-Mail: rich@shavell.net
Web Site: www.shavell.net

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Endnotes:

1. Treasury Decision 9263 05/24/06 IRC §199
2. IRC §199(a)
3. IRC §199(c)(4)(A)(ii) & (iii)
4. IRC §199(a)(1) and (b)(1)
5. Treas. Regs. §1.199-3(m)(1)(i)
6. Treas. Regs. §1.199-3(m)(1)(ii)
7. Treas. Regs. §1.199-3(m)(6)(v) Example (1)
8. Treas. Regs. §1.199-3(m)(3)
9. Treas. Regs. §1.199-3(m)(2)(i)
10. Treas. Regs. §1.199-3(m)(5)
11. Treas. Regs. §1.199-3(m)(2)(iii)
12. Ibid.
13. Treas. Regs. §1.199-3(m)(1)(iii)(A)
14. Treas. Regs. §1.199-3(m)(6)(v) Example (8)
15. Treas. Regs. §1.199-3(m)(4)
16. Treas. Regs. §1.199-3(m)(2)(ii)
17. Treas. Regs. §1.199-3(m)(2)(iii)
18. Treas. Regs. §1.199-3(m)(2)(iv)
19. Treas. Regs. §1.199-3(m)(6)(i)
20. Ibid.
21. Treas. Regs. §1.199-3(m)(6)(v) Example (2)
22. Treas. Regs. §1.199-3(m)(6)(ii)
23. Treas. Regs. §1.199-3(m)(2)(i)
24. Treas. Regs. §1.199-3(m)(6)(iv)(A)
25. Treas. Regs. §1.199-3(m)(6)(v) Example (3) & (4)
26. Treas. Regs. §1.199-3(m)(6)(iv)(A)
27. Ibid.
28. Ibid.
29. Ibid.
30. Treas. Regs. §1.199-3(m)(6)(v) Example (5)
31. Treas. Regs. §1.199-3(m)(6)(v) Example (6)
32. Treas. Regs. §1.199-3(n)(1)
33. Ibid.
34. Treas. Regs. §1.199-3(n)(2)
35. Treas. Regs. §1.199-3(n)(3)
36. Treas. Regs. §1.199-3(n)(5)
37. Treas. Regs. §1.199-3(n)(6)(i)