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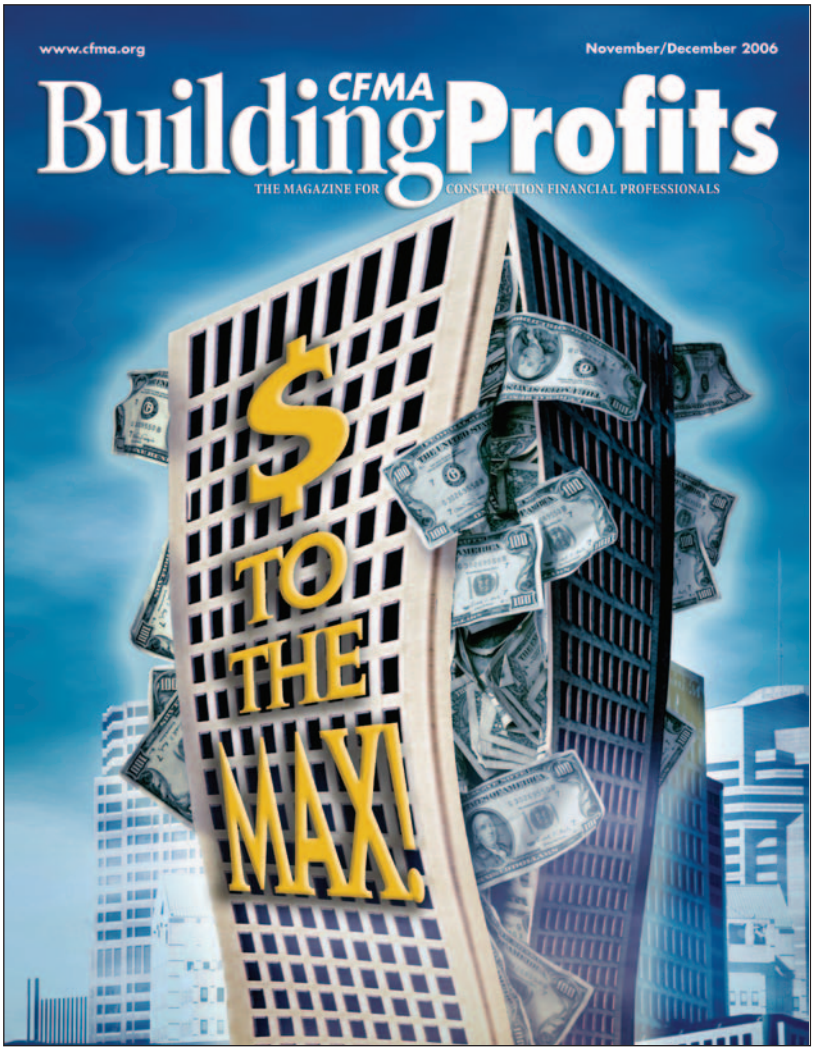

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The Source & Resource for Construction Financial Professionals

A CFMA SPECIAL REPORT:

BY RICHARD R. SHAVELL

DPAD Regulations Finalized, Part 2

Contractors warmly welcomed the Domestic Production Activities Deduction (DPAD). But, now that guidance is almost complete, many are wondering how to take advantage of this substantial tax reduction.

Background

As discussed in "A CFMA Special Report: DPAD Regulations Finalized, Part 1" in the last issue, taxpayers may claim a deduction to offset income from certain construction, architectural, and engineering services.

This deduction, detailed in IRC §199 and Treasury regulations, equals the lesser of two amounts for the tax year:

1) A percentage of the smaller of:

- the taxpayer's Qualified Production Activities Income (QPAI) or
- taxable income

2) 50% of the employer's W-2 wages

For contractors, the percentage could be substantial: 3% for tax years beginning in 2005 and 2006, 6% for tax years beginning in 2007-2009, and 9% in later years.

Exhibit 1 on the next page also appeared in Part 1, and provides a basic example of the computation. But, like most construction projects, there are a number of intricacies involved and several unknowns that Treasury has yet to resolve.

This article highlights these areas and discusses other issues that impact contractors, including:

- Wage limitations and qualified wages
- Cost allocations
- Pass-through entities
- AMT
- Effective Dates and Transition Rules

Because forewarned is forearmed, we'll look at each of these topics in turn, with a focus on areas of special interest to contractors.

The Wage Limitation

The DPAD is limited to one-half of the wages reported on Forms W-2, as filed with the Social Security Administration (SSA).[1] This is one of the simplest rules in the deduction, but there have been a few changes since the DPAD's inception, primarily due to the *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA).

Tax Increase Prevention & Reconciliation Act

As part of TIPRA, Congress recently modified the DPAD's wage limitation rules. For tax years beginning after May 17, 2006, only wages properly allocable to domestic production gross receipts (DPGR) are allowed for purposes of the wage limitation.[2]

This wage limitation could reduce the tax benefits of §199 for contractors who are heavily dependent on subcontractors and independent contractors. For example, a roofing contractor who hired 15 workers as independent contractors wouldn't have W-2 wages to report for those workers, and could potentially have a smaller deduction than a contractor with 15 employees who self-performed the job.

Also, for tax years after May 17, 2006, TIPRA repeals a special limitation on wages treated as allocated to partners or shareholders of pass-through entities. Under the repeal, each partner's or shareholder's W-2 wages for the tax year are equal to the allocable share of the partnership's or S corporation's W-2 wages for the tax year.[3]

Editor's Note: For more information on TIPRA, see "New Tax Law Provides Tax Relief, Leaves Some Tax Provisions Unsettled" by Jeffrey Kummer in the July/August 2006 issue.

Calculating W-2 Wages

After the TIPRA change, the IRS released Rev. Proc. 2006-22, which explains the methods for calculating W-2 wages for §199:

1) Unmodified Box Method

2) Modified Box One Method

3) Tracking Wages Method[4]

In general, most contractors will choose the Unmodified Box Method, which is the simplest and least burdensome approach. However, if this method reduces their DPAD, then contractors should consider the other two methods, especially if either method yields a better result. Here's an explanation of each.

Unmodified Box Method

Under the Unmodified Box Method, W-2 wages are calculated, without any modification, as the lesser of:

1) The total entries in Box 1 of all Forms W-2 filed with the SSA, or

2) The total entries in Box 5 of all Forms W-2 filed with the SSA by the taxpayer.

In most cases, this is the simplest way to determine wages for the §199 wage limitation, because contractors simply refer to the aggregate Forms W-2 information on Forms W-3. However, the Modified Box One and the Tracking Wages Methods are slightly more involved.

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 Production Activities 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

Modified Box One Method

Under the Modified Box One Method, taxpayers adjust the total amount reported in Box 1 of Forms W-2 by:

- Subtracting from Box 1 certain amounts that are not wages for federal income tax purposes, but are treated as wages for income tax withholding (for example, supplemental unemployment compensation benefits).
- Adding amounts reported in Box 12 of Forms W-2 with codes that represent such tax-exempt or tax deferred income as 401(k) contributions.

The objective is to increase the qualified wages within the limits allowed by law. So, contractors whose deferred compensation exceeds the amounts requiring subtraction could earn a larger deduction through the Modified Box One Method. For example, contractors with excellent participation in their qualified plans may benefit from this method.

Tracking Wages Method

Under the Tracking Wages Method, taxpayers track total wages subject to federal income tax withholding. As with the Modified Box One Method, they are entitled to certain modifications.

Next, let's consider what happens when wages are paid by an entity other than the common law employer.

Professional Employee Organizations & Leasing Companies

Many contractors pay a lump sum to a professional employee organization (PEO) or leasing company that serves as the employer for purposes of IRS reporting.

This arrangement often benefits contractors in several ways. For example, a PEO handles many more employees than the typical contractor, so the PEO can purchase insurance coverage on a large scale and earn discounts on workers' comp and health insurance.

The final regulations indicate that the contractor may include wages paid by another entity (the PEO or leasing company) and reported by the other entity on Forms W-2, if the wages were for the true employment by the contractor.[5]

In addition, the regulations suggest that taxpayers can include wages paid to employees as defined under §3401(d)(1). This section of the Code treats those with control of wages as an employer for employment tax purposes, even if that entity is not the wage payee.[6]

In essence, if workers are truly common law employees of the contractor, then it can include those wages in the W-2 limitation – even though the wages are not reported on Forms W-2 issued by the contractor.[7]

Editor's Note: Just prior to this article's printing, Rev. Proc. 2006-47 and temporary regulations issued under Treasury Decision 9293 were released. These sources provide more information on the subtleties of W-2 calculations.

Zero Wages & Entity Selection

Interestingly, some taxpayers cannot qualify for the DPAD be-cause wages are not present. For example, sole proprietorships and partnerships without non-partner employees will not have wages for tax purposes. (As LLCs taxed as partnerships, the partners do not receive W-2 payments under the Code.)

TAXPAYERS may claim a **DEDUCTION** to offset **INCOME** from certain CONSTRUCTION, ARCHITECTURAL, and ENGINEERING services.

However, a sole shareholder of an S corporation would pay at least reasonable compensation to him- or herself as an employee and would have wages against which the 50% wage limitation could apply.

In some cases, LLCs treated as partnerships could elect to be treated as a corporation, then file an S election. Under this corporate structure, wages could be paid to the members who – solely for tax purposes – were previously taxed as partners, but are now treated as S corporation shareholders.[8]

Whether or not this wage limitation will affect entity selection remains to be seen, but it is a nuance that deserves consideration.

Cost Allocations

The following cost allocations involve complicated rules. However, as you review this material, it's important to remember that the DPAD is a significant deduction, and well worth the effort for many contractors.

As mentioned in Exhibit 1, DPGR is computed and then reduced by three attributable items:

- Cost of goods sold (CGS)
- Direct expenses
- Indirect expenses

So, how should contractors compute these allocable expenses and what methodologies should apply? Contractors do not report any CGS because construction costs reflected on the typical GAAP financial statement are, for DPAD purposes, considered part of the direct expenses attributable to DPGR.

The indirect costs category would be costs allocable from overhead or G&A. There are generally three choices to compute direct expenses attributable to DPGR:

- Section 861 Method
- Simplified Deduction Method
- Small Business Simplified Overall Method[9]

Section 861 Method

Under the regulations, gross income attributable to DPGR and deductions allocable to DPGR should generally be computed under the §861 Method.

While the Code contains the §861 Method for other purposes, it is specifically referenced as the preferred technique to compute the DPAD. However, practical considerations such as a contractor's job costing and accounting system are more likely to dictate costs allocations.

Depending on contractor size, the overwhelming majority of contractors will employ the Simplified Deduction Method (SDM) or the Small Business Simplified Overall Method (referred to as SBSOM throughout this article).

But, before we discuss SDM and SBSOM, let's analyze §861 and the overall transactional approach of various accounting methods.

Percentage-of-Completion Method

Some believe that under the PCM, the regulations require contractors to recompute their PCM income based on the expenses that directly apply to DPGR. A close reading of the regulations could lead one to this conclusion. However, from a practical perspective, it may not make sense to go to this extent.

Consider a contract that includes some revenue and costs that qualify as DPGR and some that do not. Under such a mixed contract, the transaction view would eliminate the non-qualifying contract revenue and costs from the PCM computation.

The following example of a mixed contract shows the difference between gross profit, earned revenue, gross profit for regular tax purposes, earned revenue for DPAD purposes, and gross profit for DPAD purposes:

Gross Profit: If a contractor has a $1 million contract and $800,000 of total estimated costs, we would expect a *gross profit of $200,000* on the contract.

Earned Revenue: The contractor has incurred $400,000 of costs so far. The project is 50% complete ($400,000 divided by $800,000), so the contractor would recognize *$500,000 of earned revenue.*

Gross Profit for Regular Tax Purposes: We reduce the earned revenue of $500,000 by contract costs of $400,000 for a *gross profit of $100,000 for regular tax purposes.*

Earned Revenue for DPAD Purposes: Let's assume that $100,000 of the $1 million contract is for services that do not qualify as DPGR. Also, only $360,000 of the $400,000 of costs-to-date qualify and $740,000 of the $800,000 total estimated costs for activities qualify.

The new PCM equation is $360,000 divided by $740,000, resulting in a percentage-of-completion of approximately 48.65%.

Now, we multiply this percentage by $900,000 ($1 million minus $100,000 in non-qualifying services), resulting in *earned revenue for DPAD purposes of approximately $438,000.*

Gross Profit for DPAD Purposes: Next, we reduce the $438,000 by the $360,000 of costs allocable to the contract for qualifying activities – the result would be *$78,000 of gross profit for DPAD purposes.*

While the gross profit for DPAD purposes is significantly less than the $100,000 gross profit for regular tax purposes, there's an underlying issue. Did Treasury intend for contractors to perform secondary computations on a contract-by-contract basis?

Typically, 100% of construction contract revenue will qualify, making recomputations of the PCM income unnecessary. However, one could argue that the regulations require these secondary computations to determine DPAD earned revenue and allocable costs.

Informal discussions with IRS personnel indicate that Treasury did not intend for contractors to recompute PCM solely for DPAD purposes. But, no conclusive guidance has been issued to date.

The Accrual, Cash & Completed Contract Methods

Next, let's consider those who report on a straight accrual basis. Again, with a job cost system in place, contractors should be able to isolate direct costs, as well as the revenue applicable to each job.

It will be interesting to see the impact of this deduction under the cash method when contractors have costs in one year, but earn the corresponding revenue in a different year for tax purposes. Contractors prone to significant swings in income and expenses may have difficulty maintaining a consistent annual DPAD.

Under the completed contract method (CCM), there would also be similar timing concerns. But, the costs would be recognized in a similar fashion and timed against the revenue.

Also, certain costs under §861 would be treated as costs allocable to projects. This differs under the PCM, the CCM, and other methods, where some of these same costs would be considered period costs and not direct job costs – for example, state income tax and research and development expenses related to qualified production income,[10] which are typically period costs under §460.

Because most contractors will qualify under one of the simplified methods, few construction companies will be overly concerned with the §861 Method. As always, once an approach is chosen, it should be applied consistently.

Simplified Deduction Method

Under the SDM, a contractor's deductions are ratably apportioned between DPGR and non-DPGR based on relative gross receipts.[11]

The SDM is available to simplify allocations, but it does not apply to CGS. Luckily, this is not a concern for contractors because their direct costs are not part of CGS.

A contractor eligible to use the SDM has average total assets of $10 million or less or annual gross receipts of $100 million or less.[12] This $100 million threshold will cover most contractors, enabling a significant majority

to use this method.[13] Here are some scenarios to help CFMs understand the SDM.

Two Lines of Business

Let's say a contractor has two lines of business and has a qualified DPGR of $20 million and non-qualifying receipts of $5 million. The direct expense attributable to the DPGR can simply be computed at 80% of total direct costs.

Pass-Through Entities

If an owner of a pass-through entity qualifies and uses the SDM, then the SDM must be applied at the *level of the owner* of the pass-through entity. The owner must take into account its DPGR, non-DPGR, and other items from all sources, including the distributive or allocable share of the pass-through entity's items.

Similarly, whether or not a trust or an estate may use the SDM is determined at the trust or estate level. This may be a significant point because the owner may have other entities from which additional pass-though information is required.

Expanded Affiliated Groups

For purposes of the SDM, total assets equal the assets the contractor reports at the end of the taxable year. For example, a C corporation would look to Schedule L of Form 1120.[14] A pass-through shareholder of an S corporation would have to receive that information from the S corporation return.

For an expanded affiliated group (EAG), the tax advisor would look at all members of the EAG to determine if the members of the EAG would use the SDM.

If all of the members qualify as a group, then each member elects the cost allocation method it wants to use, regardless of the methods chosen by the other members of the EAG. However, all the members of a group that join in filing a consolidated tax return are required to use the same cost allocation method.[15]

The regulations provide several examples to illustrate EAG method selection issues:

Example 1: Corporations X, Y, and Z are the only three members of an EAG, and none are members of a consolidated group. X, Y, and Z have average annual gross receipts of $20 million, $70 million, and $5 million, respectively.

In addition, each member has total assets of $5 million at the end of the taxable year. Because the average annual gross receipts of the EAG are less than $100 million, each member of the group may use either the SDM or the §861 Method.

Example 2: The facts are the same as in Example 1, except that Corporations X and Y are members of the same consolidated group. Each member may use either the SDM or the §861 Method. However, X and Y must use the same cost allocation method.

Example 3: The facts are the same as in Example 1 except that Corporation Z's average annual gross receipts are $15 million.

Because the average annual gross receipts of the EAG are greater than $100 million and the total assets of the EAG at the end of the taxable year exceed $10 million, all members of the group *must* use the §861 Method.[16]

Editor's Note: For further information on EAGs, including additional examples, see Exhibit 2 on the following page.

Exhibit 2: The ABCs of Construction EAGs

An EAG is an affiliated group with ownership attribution of "more than 50%." Under normal circumstances, all members of an EAG are treated as a single corporation for purposes of the DPAD.[17]

There are special rules for EAGs that have members entering and exiting the group during the tax year, as well as special rules for EAG members with different taxable years.

In most industries, EAGs must initially compute their qualified production activities separately. However, for the construction industry, as well as engineering and architectural services, there is a special rule that treats EAGs differently.

The EAG attribution rule that normally applies with respect to property related activities does *not* apply to gross receipts from these construction activities. To qualify, a member of an EAG must be engaged in a construction activity or provide engineering or architectural services for that member's gross receipts to be derived from construction, engineering, or architectural services.[18]

When one member of an EAG engages in construction activities, only that member can claim eligible gross receipts for services as DPGR. Here are two examples adapted from the regulations:

Example 1: Corporations X and Y are members of an EAG. Corporation X owns a building, and retains Corporation Y, a GC, to oversee a substantial renovation of that building.

Corporation X engages in no actual construction-related activities, while Corporation Y's activities with respect to the renovation are treated as construction activities under the regulations. Following the renovation, Corporation X sells the building to an unrelated party.

If Corporation X had constructed the building, its receipts from the sale would be DPGR. However, even though they are members of the same EAG, Corporation Y's construction activities are not attributed to Corporation X.

Corporation X is not treated as having engaged in construction activities with respect to the building, and its gross receipts from the sale of the building do not qualify as DPGR.[19]

Example 2: Corporations A and B are members of the same EAG, but are not members of the same consolidated group. Corporation B is not engaged in any activities that qualify as the construction of real property.

Corporation A constructs a building in the U.S., and the gross receipts are eligible for the DPAD. If Corporation A sells the building to an unrelated person, the gross receipts from the sale are DPGR.

What if Corporation A sells the building to Corporation B, and Corporation B sells it to an unrelated person? Under these circumstances, Corporation A's construction activities are not attributed to Corporation B, and Corporation B's receipts from the sale of the building do not qualify as DPGR.[20]

Therefore, these rules will have less impact on construction, engineering, and architectural services because each entity providing these services must compute its DPAD separately.

Small Business Simplified Overall Method

Contractors who meet certain size qualifications can use the SBSOM to apportion their CGS, the direct expenses attributable to DPGR, and their indirect expenses. Under the SBSOM, a contractor's total costs are based on relative gross receipts and apportioned between DPGR and non-DPGR.[21] To qualify for this method, contractors must:

1) Have average annual gross receipts of $5 million or less, or

2) Be eligible to use the cash method under Rev. Proc. 2002-28. This would include taxpayers with average annual gross receipts of $10 million or less that are not prohibited from using the cash method under §448, including partnerships, S corporations, C corporations, or individuals.[22]

The second exception permits contractors to use the cash method, an accommodation made by the IRS in the late 1990s.

Consolidated Returns

For a group filing a consolidated return, qualified production activities income (QPAI) under the SBSOM is determined on a consolidated basis by its members' DPGR, the receipts that do not qualify, CGS, and all other deductions, expenses, or losses.

However, for the purposes of this computation, gross receipts do not include gross receipts allocated to land under the land safe harbor.

Land Costs

Before they apply the SBSOM, contractors must reduce total costs for the current taxable year by the costs of land and any other costs capitalized to the land.

For example, if a contractor has $100,000 in total costs for the current taxable year and $60,000 of such costs is attributable to land under the land safe harbor, then only $40,000 of such costs is apportioned between DPGR and non-DPGR under the SBSOM.[23]

Revenue Thresholds

To meet the revenue thresholds for both the SBSOM and the SDM, taxpayers compute the average annual gross receipts for the prior three years preceding the current taxable year.

This is true even if one or more of the years occurred before the effective date of §199. In the case of a taxable year of less than 12 months, contractors annualize the gross receipts based on the number of months in the short year. Receipts include gross receipts attributable to the sale, exchange, or other disposition of land under the safe harbor method.[24]

The average annual gross receipts computation for DPAD is similar to – but not the same as – the computation that a contractor would undertake to determine the availability of the small contractor exception under §460(e).

Expanded Affiliated Groups

To compute the average annual gross receipts of an EAG, the gross receipts for the entire taxable year of each corporation that is an EAG member at the end of its taxable year (that ends with or within the taxable year of the computing member) are aggregated. For contractors filing a consolidated return, the consolidated group is treated as one member of the EAG for purposes of this computation.[25]

The regulations provide a few examples:

Example 1: Corporations L, M, and N are the only members of an EAG, and none of them are members of a consolidated group. L, M, and N have average annual gross receipts for the current taxable year of $1 million, $1 million, and $2 million, respectively.

Because the average annual gross receipts of the EAG are less than $5 million, all three members of the EAG may elect to use the §861 Method, the SDM, or the SBSOM.

Example 2: The facts are the same as in Example 1, except that Corporations M and N are members of the same consolidated group. The members of the group may use the §861 Method, the SDM, or the SBSOM. However, Corporations M and N must employ the same cost allocation method.

Example 3: The facts are the same as in Example 1, except that Corporation N has average annual gross receipts of $4 million. Because the average annual gross receipts of the EAG are greater than $5 million, no member of the EAG can use the SBSOM. This is true unless an exception is met and the EAG, viewed as a

single corporation, is eligible to use the cash method under Rev. Proc. 2002-28.[26]

Pass-Through Entities

This is probably the most complex area in the application of the DPAD regulations. Because of the intricacies involved and the significant number of S corporations in construction, this discussion will be limited to S corporations. However, there are special rules for partnerships, trusts, and estates. CFMs should contact their tax advisors about their individual company's pass-though issues.

During the commentary process, Treasury received several letters and oral testimony regarding pass-though entities and the complexity of the computations. As a result, a modification in this area is anticipated – although at this point, the outcome is still unclear.

As previously mentioned, the DPAD is generally applied at the owner level consistent with the economic arrangement of the pass-through entity owners. Each owner should compute its deduction, taking into account its distributive or proportionate share of the pass-though entity's items.

The S corporation is required to pass-through data to its shareholders so that each respective shareholder can compute its DPAD at the shareholder level.[27] This is a substantial burden. There will be some unusually large numbers on the S corporation's Schedule K and the shareholders' Schedule K-1 that must be explained in the supplementary information for each K-1.

For each of its shareholders, the S corporation must produce the proportion and share of QPAI, DPGR, non-DPGR, W-2 wages, CGS, direct expenses attributable to DPGR, and indirect expenses attributable to DPGR. In addition, because of the SDM rules, the shareholder needs to know if the entity elects the SDM. This multiplies the number of computations and the required information.

TIPRA's Impact

IRC §199(d)(1)(c) is a new section added as a result of TIPRA. This new section indicates that the Secretary may prescribe reporting requirements and rules that require or restrict the allocation of items and wages.

In the Preamble to the final regulations, Treasury indicates the need to address the complexity of performing the computations at the shareholder level.

Also, it is considering a proposal to perform the entire DPAD computation at the entity level, which would simplify the process by eliminating the necessity of passing information through to shareholders. Under this scenario, the S corporation would deduct the DPAD from the S corporation's pass-though income.

The language in the regulations indicates that Treasury may prescribe rules to eliminate the pass-though computations. At this point, no such rules have been issued, but simplification is anticipated.

But, let's get back to the current rules.

Aggregate Pro-Rata Share of Pass-Through Items

To determine its DPAD for the tax year, the S corporation shareholder would aggregate its pro-rata share of the items passed through by the entities to the extent the deduction was not disallowed by the Code (e.g., lack of basis). The pass-though items would be aggregated with items incurred outside the S corporation. Then, shareholders would compute their QPAI.[28]

However, if the S corporation uses the SBSOM, then shareholders are allocated their share of QPAI rather than specific items. The QPAI is then aggregated or combined with the QPAI from other sources.

Under this method, a shareholder's portion of the QPAI from an S corporation can fall below zero. However, if the S corporation uses the SBSOM, then the shareholder may use any other eligible method to figure the QPAI from other sources.

Disallowed Deductions

Generally, there are three limitations on a shareholder's ability to take a loss or deduction:

1) Section 465, At Risk Rules,

2) Section 469, Passive Activity Loss Rules, and

3) Section 1366(d) Rules that limit corporation shareholders' distributive share of the S corporation's losses to the adjusted basis in stock and the corporation's direct debt owed to the shareholder.

This article will not delve into these technical limitations, but contractors should note the treatment of the DPAD if one of these limitations prevents the use of the deduction in the current year. If any previously disallowed losses or deductions are allowed in a later year, then shareholders can include their respective share of previously disallowed losses or deductions when computing QPAI for that later year.[29]

There is a transition rule for tax years before the enactment of §199. If the losses or deductions that are later "freed-up" were disallowed in years beginning on or before December 31, 2004, then they cannot be considered when computing the QPAI or wage limitation – even if the losses or deductions are later permitted for other purposes.

Special Non-Attribution Rule

Generally, the owner of a pass-through entity, such as an S corporation shareholder, does not need to be directly engaged in the entity's trade or business to claim the DPAD on a proportionate basis. However, attribution of activities between pass-through entities and their owners does not apply.

The owner of the pass-though entity is not treated as though it performs the services that qualify under the deduction for the pass-though entity and vice versa.[30]

Under the regulations, this attribution of activities appears to mean attribution of construction, engineering, and architectural services conducted by the pass-through entity to its owners in their individual capacities – and, conversely, those activities conducted by the S corporation shareholder in his or her individual capacity, as it would apply to the entity.

This special non-attribution rule appears to focus on situations where the owner of the pass-through entity provides services in an individual capacity that is not part of the entity's activity.

Under these circumstances, it seems that the owner's separate activities cannot be treated as activities of the entity; also note that other owners of the entity cannot claim the deduction for the activities of other shareholders.

This could impact shareholders who are truly non-material participants in the S corporation's activities. Affected contractors and their tax advisors should analyze this nuance closely and manage their activities accordingly.

Alternative Minimum Tax

Many small contractors face the AMT, because under §460(e), small contractors with average annual gross receipts under $10 million are entitled to use an accounting method other than the PCM. However, for AMT purposes, long-term contract income must be recognized under the PCM.

So, small contractors tend to face the AMT either annually or periodically. This depends on the expansion and contraction of their deferred income reported under their regular accounting method compared to the PCM.

When determining alternative minimum taxable income (AMTI), taxpayers must determine QPAI without regard to any AMT adjustments under §56-§59, and apply the income limitation for the DPAD calculation by substituting AMTI for taxable income.[31]

This rule can be significant because affected contractors must perform a separate DPAD calculation for AMT purposes, without the adjustments under §56-§59. This includes the long-term contract adjustment for AMT purposes under §56(a)(3).

The regulations also indicate that contractors cannot include the §199 deduction when they determine the alternative tax net operating loss (ATNOL) deduction. The following example, included in the regulations, assumes that for calendar year 2007, a taxpayer has:

1) AMTI (before the ATNOL and §199 deductions) of $1 million,

2) QPAI of $1 million,

3) ATNOL carryover to 2007 of $5 million, and

4) W-2 wages in excess of the wage limitation.[32]

Under §56(d), the ATNOL deduction for 2007 is $900,000 (90% of $1 million), which reduces AMTI to $100,000. The ATNOL carryover to 2008 is $4.1 million. The taxpayer must then further reduce the AMTI by the §199 deduction of $6,000 (6% of the lesser of $1 million or $100,000) to $94,000.

The **DPAD** will have a **SIGNIFICANT IMPACT** on contractors . . . After all, Congress rarely provides a **DEDUCTION** of **UP TO 9%** of a CONTRACTOR'S **ANNUAL NET INCOME.**

How would this affect small contractors who consistently face the AMT adjustment under §56(a)(3) for long-term contracts? A small contractor using the CCM in year one may be faced with the AMT because of a significant adjustment under §56(a)(3).

However, that adjustment cannot be used when computing the AMTI. The result? The AMTI would be lower for that year and, because of the income limitation, it could preclude the small contractor from securing any DPAD for AMT purposes.

Comments submitted to the IRS expressed concern that because the AMT is a separate system,[33] the adjustment under §56(a)(3) must be considered in the DPAD computations for AMT purposes.[34]

Effective Dates & Transition Rules

The effective date rules are also confusing. Section 199 applies to taxable years beginning after December 31, 2004.[35] But, taxpayers may follow one of several different sets of rules for computing their DPAD during the early implementation of §199:

1) Revenue Notice 2005-14,

2) Proposed regulations issued November 4, 2005,

3) Final regulations issued in May 2006 (§1.199-1 through §1.199-8), or

4) Final regulations as adjusted before TIPRA (§1.199-9).

Consider the following possibilities:

- The final regulations are generally applicable for tax years beginning on or after June 1, 2006.
- For taxable years beginning on or before May 17, 2006 (TIPRA's enactment date), taxpayers may elect to apply the final regulations if they follow all provisions in the final regulations to the taxable year.
- For taxable years beginning after May 17, 2006 and before June 1, 2006 (generally only the tax year ending May 31, 2006), taxpayers may apply the final regulations without regard to the TIPRA additions.
- Alternatively, taxpayers can choose not to rely on the final regulations for tax years beginning before June 1, 2006. Generally, they would rely on the guidance provided in the proposed regulations and/or Notice 2005-14.[36]
- Section 1.199-9 addresses certain pass-through entity rules before the TIPRA changes and may be applied, with certain limitations, to taxable years that begin before May 17, 2006.

In addition, when determining the DPAD, items arising from a taxable year of a pass-through entity beginning before January 1, 2005 do not count for purposes of §199.[37] Members of an EAG that are not members of a consolidated group may apply the effective date rules without regard to how other members of the EAG apply the effective date rules.[38]

There are also rules about how to apply differences between the Notice and the proposed regulations, or the Notice and the final regulations.[39]

And, as this issue went to press, the IRS issued temporary regulations generally effective October 19, 2006 under Treasury Decision 9293. When deciding which rules to follow during the transition period, CFMs should consider the impact of these temporary regulations on pass-through entities and the wage limitation.

Conclusion

The DPAD will have a significant impact on contractors in the following years. After all, Congress rarely provides a deduction of up to 9% of a contractor's annual net income.

Despite the deduction's complexity, the process will be worth the effort and administrative burden. Over time, the DPAD computations will become routine if contractors and their CFMs work closely with their tax advisors to develop a strategy to maximize the §199 deduction.

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Endnotes:

1. Treas. Regs. §1.199-2(a)(1)&(3)
2. IRC §199(b)(2)(B), as amended by TIPRA.
3. IRC §199(d)(1)(A)(iii)
4. Rev. Proc. 2006-22, IRB 1033, 5/24/06
5. Treas. Regs. §1.199-2(a)(2)
6. Ibid.
7. Ibid.
8. Preamble to Proposed Regulations, Income Attributable to Domestic Production Activities.
9. Treas. Regs. §1.199-4
10. Treas. Regs. §1.861-8(e)(6) and §1.861-17(a)(1)
11. Treas. Regs. §1.199-4(e)(1)
12. Treas. Regs. §1.199-4(e)(2)
13. Associated Builders and Contractors, comments to the IRS, January 3, 2006.
14. Treas. Regs. §1.199-4(e)(3)(i)
15. Treas. Regs. §1.199-4(e)(4)
16. Treas. Regs. §1.199-4(e)(4)(iii)
17. Treas. Regs. §1.199-7(a)
18. Treas. Regs. §1.199-7(a)(3)(ii)
19. Treas. Regs. §1.199-7(a)(4) Example 1
20. Preamble to Proposed Regulations, Income Attributable to Domestic Production Activities.
21. Treas. Regs. §1.199-4(f)(1)
22. Treas. Regs. §1.199-4(f)(2)(i)&(iii)
23. Treas. Regs. §1.199-4(f)(3)(ii)
24. Treas. Regs. §1.199-4(g)(1)
25. Treas. Regs. §1.199-4(g)(2)
26. Treas. Regs. §1.199-4(f)(4)(iii)
27. Treas. Regs. §1.199-9(c)(1)(i)
28. Ibid.
29. Treas. Regs. §1.199-9(c)(2)
30. Treas. Regs. §1.199-9(h)
31. Treas. Regs. §1.199-8(d)
32. Ibid.
33. See Plumb v. Commissioner, 97 TC 632
34. Associated Builders and Contractors, comments to the IRS, January 3, 2006.
35. Treas. Regs. §1.199-8(i)(1)
36. Ibid.
37. Treas. Regs. §1.199-8(i)(2)
38. Treas. Regs. §1.199-8(i)(3)
39. Treas. Regs. §1.199-8(i)(1)