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BY RICH SHAVELL

DPAD Regulations Revisited: What Contractors Need to Know

As part of the *American Jobs Creation Act of 2004*, Congress passed the Domestic Production Activities Deduction (DPAD) permitting specific industries, including contractors, architects, and engineers, to deduct up to 9% of the net income of their operations. The deduction acts in part as an incentive for domestic production and to increase domestic jobs.

This article is an updated and abbreviated version of a two-part series first published in 2006 on DPAD¹ in an effort to bring attention to the potential importance and impact for contractors.

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., including manufacturing; food production; software development; film and music production; production of electricity, natural gas, or water; and construction, engineering, and architectural services.²

The DPAD equals the *lesser* of:³

- 1) 9% of the *smaller* of:
 - a. The qualified production activities income (QPAI) of the taxpayer for the tax year; or
 - b. Taxable income for the tax year.
- 2) 50% of the W-2 wages of the employer for the tax year.⁴

Turn to the next page for the fundamentals of calculating DPAD.

General Requirements

In order to deduct a DPAD for construction work, a contractor must meet three general requirements:

- 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 domestic production gross receipts (DPGR) from the construction activity.

Requirement One: Be Engaged in Construction Activity

A contractor's activities or services must be such that the contractor reports on its tax return that it is a contractor under the North American Industry Classification System (NAICS).⁵

The regulations require that the construction activity occurred on a "regular and ongoing basis." Further, under two safe harbors⁶ in the regulations, 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.

Let's examine a scenario that demonstrates this requirement.⁷ ABC Construction and Development Co., Inc., a commercial contractor and developer under NAICS code 236220, purchases a building and retains EFG Construction Co., Inc., an unrelated entity, to oversee a substantial renovation of the building.

Although not licensed as a GC, EFG performs GC-level work and activities relating to management and oversight of the construction process such as approvals, periodic inspection of the progress of the construction project, 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? Provided EFG Construction Co., Inc., HIJ General Contractors, Inc., and KLM Electrical meet all of the other requirements of the regulations, 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 regulations.

How to Calculate the DPAD

The fundamentals work like this: Assume that ABC Construction Co. has the following results for 2016 (see Exhibit 1 below):

- Gross receipts of \$10 million, 100% of which qualify as Domestic Production Gross Receipts (DPGR)
 - QPAI of \$1 million
 - Taxable income of \$1.1 million
 - W-2 wages of \$900,000
- 1) Multiply QPAI by the 9% rate (\$1 million x 9%) for a potential deduction of \$90,000;
 - 2) Compare the potential deduction of \$90,000 to the taxable income of \$1.1 million and conclude \$90,000 is smaller;
 - 3) Compare the \$90,000 to one-half of W-2 wages (\$900,000 x 50%) and conclude that the \$90,000 potential deduction is smaller. The resulting DPAD in this example is \$90,000.

Wage computation is integral to ensuring that DPAD is maximized. If the entity does not have sufficient wages, then DPAD may be eliminated. Likewise, if there is no QPAI, then DPAD will also be reduced.

Requirement Two: Perform Construction Work Involving Real Property

Substantial Renovation

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

The regulations clearly indicate that a substantial renovation or erection of a structure must take place.⁸ The regulations currently define substantial renovations as a 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.⁹

To simplify the definition, a substantial renovation would be a project for which the owner would capitalize the value of the construction upon completion. This presents an interesting situation for contractors that may be performing construction services, but may not be certain as to whether or not the services performed constitute a substantial renovation.

What if a contractor believes its services constitute a repair, but the owner believes that the work is 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 to provide power for a small, underutilized portion of the facility.

The electrical contractor may not be aware of the leasehold improvements that are to be constructed within the facility shortly thereafter, and may simply consider the services as a repair or possibly maintenance, even though these same services are integral to subsequent capital improvements soon to be performed at the site.

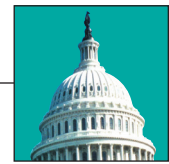
In addition, certain services such as grading, demolition, excavating, and other activities that physically transform land as activities that constitute construction.¹⁰ Under the regulations, a taxpayer engaged in these activities is asked to make a reasonable

EXHIBIT 1: Sample DPAD Calculation

ABC Construction Co., Domestic Production Activities Deduction 2016

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.



inquiry or reasonable determination as to whether the activity relates to the erection or substantial renovation of real property in the U.S.¹¹ Unfortunately, contractors may be forced to make such a decision without having complete information.

In 2011, the definition of substantial renovation was tested in Tax Court.¹² A heavy/highway contractor's income from projects that erected or rehabilitated streets, bridges, and other real property qualified as DPGR eligible for DPAD. Rehabilitation projects involving the renovation major components and the substantial structural part of freestanding items of real property was considered.

The Tax Court held that the work materially increased the value of the property as a whole, substantially prolonged its useful life, and/or adapted it to different or new use under Treas. Reg. § 1.199-3(m)(5).

As to the projects' property, which were mainly bridges damaged by casualty and unusable in whole or part, the contractor's work did more than merely bring them back to normal operating condition. The court concluded that the contractor's work restored the integrity of infrastructure, allowing it to function as intended well into future, and in most cases, also materially increased its value. And, the rehabilitation of integral infrastructure components that had severely deteriorated due to lack of care was more than routine maintenance.

Moreover, the court concluded that the property's useful life was extended by more than three years. To support this conclusion, the court looked to the specialized work and materials involved, including bridge "patching," corrosion protection, and expansion joint rehabilitation, as well as the contract dollar amounts.

Proposed Clarifications

In 2015, the IRS issued proposed regulations to further clarify the definition of construction activities. The proposed regulations would revise the definition of "substantial renovation" to conform to final regulations under Treas. Reg. § 1.263(a)-3.¹³

Generally, "substantial renovation" under the proposed regulations would agree to the definitions of an improvement outlined in the capitalization regulations:

- An amount paid for a betterment to a unit of property,
- Amounts paid to restore a unit of property, or
- Amounts paid to adapt a unit of property to a new or different use.

Although the IRS argued that a complete replacement of all major components is necessary to qualify as "substantial improvement" under DPAD, the proposed regulations conform the definitions under the capitalization regulations, where betterments may qualify as "substantial renovation." Keep in mind that the proposed regulations are not final and therefore not yet effective.¹⁴

De Minimis Exception

The regulations have a *de minimis* exception that eases certain computations. If less than 5% of a taxpayer's total gross receipts derived 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.¹⁵

For most contractors and subcontractors with homogeneous services working solely within the U.S., 100% of their gross receipts will likely qualify as DPGR.

Requirement Three: Derive DPGR from Construction Activities Tangential Services

Certain activities that may appear to be tangential to construction activities 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 providing tangential services, such as hauling trash and debris and delivering materials to the construction site, would be considered DPGR. However, if the taxpayer hauls or delivers materials without performing other construction activities, then the services do not qualify as tangential.¹⁶

The regulations indicate 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 regulations also address certain concerns regarding administrative support services, including billing and secretarial services incidental and necessary to the construction project. If the contractor performs these administrative support services as part of its construction activities, then the gross receipts qualify as DPGR.¹⁸

Real Property Sales

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

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

GC Services Clarified

The regulations clarify whether or not a GC's activities qualify as construction for purposes of DPAD, stating that activities relating to the management and oversight of the construction process (e.g., approvals, periodic inspection of the project's progress, and required job modifications) qualify as DPGR derived from construction activities.²⁰

However, the 2015 proposed regulations state that a contractor is not engaged in construction if its primary activity is limited to simply approving or authorizing invoices or payments.²¹

Developers, Architects & Engineers

In addition to these three requirements, many other aspects of DPAD can affect contractors that also serve in other capacities.

The Land Safe Harbor

DPGR does not directly result from the sale of land. If a qualifying taxpayer sells a structure built on land that is part of the sale, 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 as DPGR). This allocation can be done through an appraisal or by the safe harbor formula.

Under the safe harbor formula for allocation, the taxpayer must reduce 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.²² A percentage of such land costs must further reduce DPGR to represent the unknown increase in the land's value, 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, and installs power and water lines on the land.

Next, ABC conveys the roads, sewers, sidewalks, and power and water lines to the local government and utilities. ABC then sells the land to homebuilders that 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 regulations 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 – are DPGR.

ABC's gross receipts from the land, including capitalized costs of entitlements, *do not qualify* as DPGR under the regulations because the gross receipts are not derived from the construction of real property.²³

Safe Harbor Reduction

The safe harbor percentage reduction is based on the number of months between the date the taxpayer acquires the land and the date that the taxpayer sells each item of real property on the land.²⁴

This time frame does not include any options to acquire the land. However, a special rule may apply to an option agreement wherein 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.²⁵

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. The safe harbor percentages are:

- 5% for land that is held not more than 60 months,
- 10% for land held more than sixty 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.²⁶

The safe harbor rule helps many homebuilders and developers that would otherwise need an appraisal when they sell improved real estate to allocate the sales proceeds between the land and the structure being sold. In essence, the safe harbor percentage is a simpler approach to determine the increased value of the underlying land and should help mitigate an area ripe for tax controversy.

Because the safe harbor determination is based on a percentage, where this percentage is less than the actual increased value attributable to the sale of the underlying land, the safe harbor will generally increase the taxpayer's DPAD; the lower the amounts allocated to the land on the sale of improved real estate, the higher the amount of DPGR.

If the converse circumstances exist where the percentage is less favorable, then an appraisal may afford a better result than the safe harbor. The timing of property acquisitions, particularly during the Great Recession, may indicate whether an appraisal may be worthwhile.

Engineering & Architectural Services

DPGR also includes gross receipts derived from engineering or architectural services for a construction project performed in the U.S. (e.g., design-build contractors). While a taxpayer must be engaged in an engineering or architectural trade or business, it does not necessarily need to be its primary or only trade or business for purposes of NAICS.

Just like contractors, the engineering or architectural trade or business must be operated on a regular and ongoing basis. DPGR includes gross receipts derived from engineering or architectural services, including feasibility studies for a construction project in the U.S. – even if the planned construction project is not undertaken or not completed.²⁷

The regulations define engineering services as professional services requiring engineering education, training, and experience in the application of the 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 or erection, in connection with any construction project. The responsible supervision would be whereby the engineer is performing the services for the purpose of assuring compliance with plan specification or design.²⁸

Architectural services include the offering or furnishing of professional services (e.g., consultation, planning, aesthetic and structural design, drawings and specifications, or reasonable supervision of construction). Again, the supervision would be for the purpose of assuring compliance with plans, specifications, and designs.²⁹ However, engineering and architectural services do not include such post-construction services as annual audits and inspections.³⁰

Similar to construction services, there is a *de minimis* exception that states 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.

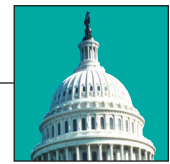
For example, these may be *de minimis* architectural or engineering services performed outside the U.S., but 100% of the gross receipts may be treated as DPGR for services performed in the U.S. on construction projects.³¹

The Wage Limitation

DPAD is limited to one-half of the wages that the taxpayer reported on Forms W-2 as filed with the Social Security Administration during the year.³² Only wages properly allocable to DPGR are allowed for purposes of the wage limitation.³³

For example, LMN's Construction Inc. has two operations that each employs workers. The first operation is providing installation of HVAC systems for new construction that results in QPAI and has 50 employees. The second operation is the service/maintenance of controls for HVAC systems that were previously installed and has 20 workers. The W-2 wages for LMN's 20 workers in the service operation are not considered in the computation of its 50% of W-2 wage limit.

Importantly, this wage limitation could reduce the benefits of IRC § 199, where taxpayers heavily depend on subcontractors and independent contractors.



For pass-through entities, each partner or shareholder is treated as having W-2 wages for the tax year equal to his or her allocable share of the partnership or S corporation's W-2 wages for the tax year.³⁴

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, since a PEO handles more employees than a typical contractor, it has the ability to bulk purchase certain types of insurance, such as workers' comp or health insurance, and earn discounts.

The regulations indicate that a contractor may take into account wages paid by another entity (i.e., the PEO or leasing company) and reported by the other entity on Forms W-2,³⁵ if the wages were for the true employment by the contractor.

In addition, the regulations indicate that taxpayers can include wages paid to "employees" as defined under IRC § 3401(d)(1),³⁶ which treats those with control of wages as an employer for employment tax purposes, even though that entity is not the common law employer of the wage payee.³⁷

Therefore, if the individual workers are truly common law employees of the contractor/taxpayer, then the contractor can include those wages in the W-2 limitation even though the wages are not reported on Forms W-2 issued by the contractor. This is the case for wages included on Forms W-2 as issued by the leasing company or PEO.

Zero Wages & Entity Selection

Interestingly, some taxpayers cannot qualify for the DPAD because wages are not present. For example, sole proprietorship and partnerships without nonpartner employees will not have wages for tax purposes. For limited liability companies (LLCs) taxed as partnerships, the "partners" do not receive W-2 payments under the IRC.

However, a sole shareholder of an S corporation would be required to 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 corporations, then file an S corporation election. Under this 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.

Of course, whether or not it makes sense to go through such structuring transitions to secure the benefits of the DPAD must be carefully considered.³⁸

Disallowed Deductions

Certain technical limitations could reduce the impact of DPAD. For example, consider three limitations that impact shareholders of an S corporation: IRC § 465, At Risk Rules; IRC § 469, Passive Activity Loss Rules; and IRC § 1366(d) rules that limit corporation shareholders' distributive share of the S corporation's losses to the adjusted basis in stock and direct debt owed to the shareholder by the corporation.

While these technical limitations are beyond the scope of this article, take note of 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 (e.g., the limitations no longer impede the shareholder from accounting for a proportionate share of those losses or deductions), then shareholders can include their respective share of previously disallowed losses or deductions when computing QPAI for that later year.³⁹

Cost Allocations

There are other complexities that impact DPAD computations that need to be considered. For example, here are three general choices to compute direct expenses attributable to DPGR: Section 861 Method, Simplified Deduction Method, and Small Business Simplified Overall Method. Also, consider how Expanded Affiliate Groups impact contractors when related entities are involved in computing DPAD.

For more on these complex issues and in-depth discussions of other DPAD nuances, review Parts 1 and 2 of "A CFMA Special Report: DPAD Regulations Finalized" in the September/October 2006 and November/December 2006 issues.

Summary

DPAD specifically applies to contractors and may have a significant impact on their company's annual tax liability and therefore cash flow. Even more than a decade later, many contractors and other taxpayers may not be aware that they may qualify for DPAD.

With such a substantial deduction of net income at stake, CFMs should consult and work closely with their tax advisor to maximize the annual impact of the DPAD. ■

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Endnotes

1. See Parts 1 and 2 of "A CFMA Special Report: DPAD Regulations Finalized" by Rich Shavell in the September/October 2006 and November/December 2006 issues.
2. IRC § 199(c).
3. IRC § 199(a).
4. IRC § 199(b).
5. Treas. Reg. § 1.199-3(m)(1)(i).
6. Treas. Reg. § 1.199-3(m)(1)(ii).
7. Treas. Reg. § 1.199-3(m)(6)(v) Example 1.
8. Treas. Reg. § 1.199-3(m)(2).
9. Treas. Reg. § 1.199-3(m)(5).
10. Treas. Reg. § 1.199-3(m)(2)(iii).
11. Treas. Reg. § 1.199-3(m)(2)(iii).
12. Adapted from *Gibson & Associates, Inc. v. Commissioner*, 136 TC 195, Code Sec(s) 199.
13. Proposed Treas. Reg. § 1.199-3(m)(5).
14. Proposed Treas. Reg. § 1.199-8(i).
15. Treas. Reg. § 1.199-3(m)(1)(iii).
16. Treas. Reg. § 1.199-3(m)(2)(ii).
17. Treas. Reg. § 1.199-3(m)(2)(iii).
18. Treas. Reg. § 1.199-3(m)(2)(iv).
19. Treas. Reg. § 1.199-3(m)(6)(i).
20. Treas. Reg. § 1.199-3(m)(2)(i).
21. Proposed Treas. Reg. § 1.199-3(m)(2)(i).
22. Treas. Reg. § 1.199-3(m)(6)(iv).
23. Treas. Reg. § 1.199-3(m)(v)(6) Example (3) and (4).
24. Treas. Reg. § 1.199-3(m)(6)(iv)(A).
25. Treas. Reg. § 1.199-3(m)(6)(iv)(A).
26. Treas. Reg. § 1.199-3(m)(6)(iv)(A).
27. Treas. Reg. § 1.199-3(n)(1).
28. Treas. Reg. § 1.199-3(n)(2).
29. Treas. Reg. § 1.199-3(n)(3).
30. Treas. Reg. § 1.199-3(n)(5).
31. Treas. Reg. § 1.199-3(n)(6).
32. IRC 199(b)(1); 199(b)(2)(C); Treas. Reg. § 1.199-2(a)(3).
33. IRC § 199(b)(2)(B).
34. IRC § 199(d)(1)(A)(iii).
35. Treas. Reg. § 1.199-2(a)(2).
36. *Ibid.*
37. *Ibid.*
38. See T.D. 9731, *Allocation of W-2 Wages in a Short Taxable Year and in an Acquisition or Disposition*, 09/14/2015.
39. Treas. Reg. § 1.199-7(c)(2).