

MEMORANDUM

TO: The American Institute of Architects

FROM: Preston Gates Ellis & Rouvelas Meeds

DATE: March 7, 2006

SUBJECT: The New Tax Deduction for Income from Architectural and Engineering Services

Overview. The tax bill that Congress enacted in 2004 contains a new deduction, for “qualified production activities,” that begins to take effect for taxable year 2005. Although this new deduction does not apply to income from most services, it *does* apply in many cases to income from architectural and engineering services. Further, although the deduction is relatively small for 2005, it is scheduled to gradually increase over the next several years.¹

This memo briefly describes the operation of the deduction with respect to architectural services, including the basic requirements, the system for allocation, the limitation to W-2 wages, and the treatment of partnerships. For specific issues, taxpayers should consult their accountant or an appropriate tax professional.

The deduction is established by Tax Code Section 199, and the calculations are governed by new IRS Form 8903.²

Basic Requirements. The deduction is determined by multiplying a phased-in percentage (3 percent for 2005) times the lesser of (i) the taxpayer’s “qualified production services income” (called “QPI” herein) or (ii) the taxpayer’s taxable income. QPI is more fully defined below; however, broadly speaking, QPI is net income from domestic operations. As example of this calculation may be helpful.

¹The deduction percentage is phased-in over 5 years. For tax years beginning in 2005, and 2006, the deduction is equal to 3% of the lesser of the taxpayer’s taxable income or qualified production activities income. For taxable years beginning in 2007, 2008 and 2009, the percentage rises to 6%. For 2010, and thereafter, the percentage rises to 9%. When fully effective, the Section 199 deduction can effectively reduce the U.S. federal income tax maximum rate on domestic production by approximately 3 percentage points: from 35% to 31.85%.

²This explanation is based on Section 199 and its legislative history, as well as on the proposed regulations issued on October 25, 2005, and the interim guidance promulgated in Notice 2005-14, I.R.B. 2005-7, 498. Final regulations are expected sometime in Spring 2006.

Example 1: In 2006, ABC has \$1 million of QPI (net income from domestic operations), but taxable income of \$750,000 due to foreign losses. ABC gets a Section 199 deduction of \$22,500 (3% x \$750,000 taxable income).

Example 2: In 2006, ABC has \$750,000 of QPI, but taxable income of \$1.0 million due to profitable foreign operations. ABC gets a Section 199 deduction of \$22,500 (3% of \$750,000 QPI).

Limitation. The amount of the deduction allowable for any taxable year is limited to 50% of the amount of wages (and elective deferrals) the taxpayer reports to employees on Forms W-2 for the taxable year.³ Independent contractors and partners do not qualify as employees. Therefore, payments to independent contractors and self-employed income, including guaranteed payments made to partners, are not included in W-2 wages. For architectural firms organized as partnerships, as opposed to C or S corporations, this limitation may significantly curtail the benefit of the Section 199 deduction. If this shortcoming is not addressed by the IRS or through legislative correction, firms may want to consider appropriate tax planning strategies, particularly as the deduction increases according to the phase-in schedule. Again, an example may be helpful.

Example 3: In 2006, ABC has QPI of \$1,000,000 and taxable income of \$750,000. ABC's W-2 wage expense for 2006 is \$40,000. ABC's Section 199 deduction is reduced from \$22,500 to \$20,000.

QPI. QPI is equal to the taxpayer's "domestic production gross receipts," or DPGR, reduced by certain allocable costs, deductions, expenses, and losses. DPGR includes income from architectural and engineering services, so long as the taxpayer is engaged in the active conduct of an architectural or engineering business, the services were performed in the United States in the course of that business, and the services were performed with respect to the construction of real property in the United States.

IRS regulations define architectural services to include consultation, planning, aesthetic and structural design, drawings, and specifications, and responsible supervision of construction (for purposes of assuring compliance with plans, specifications, and design) or erection, in connection with any construction project.

Allocation. A taxpayer must reduce its DPGR by the allocable amount of expenses, losses, and other deductions. IRS regulations provide three allocation methods. One, the "Section 861 Method," is the generally applicable method; the other two, the "Simplified Deduction Method" and the "Small Business Simplified Overall Method," are alternatives that are available only to taxpayers that meet certain small business criteria that are described in the regulations and IRS Notice.

Partnerships. The deduction is determined at the partner level, so each partner must compute its deduction separately on Form 8903 using allocations specially reported on the “other deductions” line of Schedule K-1. Each partner is allocated, in accordance with partnership principles, its share of partnership items attributable to qualified production activities including gross receipts that are DPGR, expenses that are allocated to such DPGR, and W-2 wages.