

Benefits of The American Job Creations Act of 2004

On October 22, 2004, President Bush signed into law The American Jobs Creation Act of 2004 (the “Act”). The Act contains sweeping changes to the tax landscape for businesses in many areas. Many people do not realize that the Act provides significant tax advantages for real estate developers, builders, contractors, sub-contractors and many other businesses.

The Act is perhaps best known for changing the playing field in the film and television industries by creating tax relief for those taxpayers that invest in qualifying film and television projects. Less widely known is that the Act provides tax incentives and relief, under Section 199, for those individuals, companies and small businesses that produce and/or manufacture products or tangible property. This article highlights what production activity falls under the Act, who qualifies under the Act, and some of the incentives that are available.

To qualify as Production Activity and be entitled to tax relief, one must produce, grow, or extract an eligible item. Section 199 of the Act does not apply to sole proprietors, but can be passed through to individual owners by companies that are Subchapter S corporations, partnerships, and LLCs not taxed as corporations. The Production Activity must be conducted in whole or “significant part” in the United States and it must produce tangible property such as real estate and other goods. (“Qualifying Production Activity”). The Act defines a “significant part” to mean 20 percent or more. If your company manufactures 20 percent or more in the United States, then your company is deemed to have manufactured 100 percent in the United States and all your revenue from the Qualifying Production Activity qualifies for the tax benefits under Section 199 of the Act. If your company has at least 95 percent of its revenue generated from Qualifying Production Activity, then Section 199 of the Act allows your company to apply 100 percent of your revenue as Qualifying Production Activity. If your company is a developer, builder, contractor or subcontractor of residential or commercial real estate or provides engineering or architectural services to these real estate related production activities, your company is engaged in Qualifying Production Activity under Section 199. Your company will therefore be entitled to benefits under Section 199 of the Act, as defined below.

The benefits for your company under the Act for Qualifying Production Activity are as follows:

A business that engages in Qualifying Production Activity between January 1, 2005, and December 31, 2006, is entitled to take a 3 percent deduction of the lesser of the following: (a) net income from the Qualifying Production Activity, or (b) taxable income (which is determined without regard to the new deduction). The deduction increases to 6 percent from January 1, 2007 through December 31, 2009. Beginning in 2010, and thereafter, the deduction increases to 9 percent. However, you must deduct net operating carry over losses from revenue before you can apply the percentage deductions.

There is currently no carry forward on any unused tax relief. As an example of each, if you manufacture 100 widgets in the United States and sell all 100 widgets in 2006 for \$1,000, you have \$970 as revenue subject to tax. If it is manufactured in 2008 and sold in 2008 or 2009 for \$1,000, you have \$940 as revenue subject to tax. If manufactured after 2010 and sold after 2010, you have \$910 as revenue subject to tax.

If a company performs 20 percent or more of Qualifying Production Activity within the United States, that company may include all indirect costs and other indirect expenses related to that activity (such as salaries) but may not include packaging, shipping and freight in the calculation of revenue qualifying for the deduction. Further, if your company has employees, you will be able to deduct from revenue an amount which is not greater than 50 percent of the W-2 wages for all your employees as it relates to your Qualifying Production Activity. The 50 percent cap of W-2 wages is a significantly high amount in most circumstances.

What is probably not well known is that real estate developers, builders, contractors, and sub-contractors engaged in building or improving real estate may qualify under the Act as companies that have Qualifying Production Activity. The Qualifying Production Activity can be performed on residential or commercial real estate. To the surprise of many, the benefits under the Act even cover architects and engineers who provide services to Qualifying Production Activity in the business areas of real estate developers, builders, contractors and subcontractors engaged in building or improving real estate. Section 199 will apply to revenues from rentals, leases, license fees and exchange and other disposition of Qualifying Production Activity income in the various areas of the real estate industry as described herein. However, the value of any real property (land) which is part of the sale, disposition or exchange does not qualify as Qualifying Production Activity income. The recommendation is that there should be a separate appraisal to determine the land value and then deduct that value from the income received. Only the balance attributable to improvements made with Qualifying Production Activity will be subject to the deductions under Section 199.

Only one company can claim the Qualifying Production Activity revenue under the Act. You can, however, split the benefits. If Company A contracts with unrelated Company B to manufacture 100 widgets, only one of the companies can take advantage under the Act. The test is who benefits and who carries the burdens of the property manufactured. Under this example, Company A, because it paid for the widgets, can claim the benefits under the Act. However, this should not be left for interpretation or misunderstandings. It would be better to have this issue discussed and addressed at the contract stage.

Some other businesses that may have Qualifying Production Activity include caterers and restaurants who make or prepare food products and who cater or deliver off site, music, film, video, natural gas, water and printing companies, software developers and bakers, baking companies and baking departments in supermarkets, farmers and companies that provide storage and handling for farm products. It also applies to many other types of companies and businesses.

One must evaluate their business and check with their tax advisors as to whether their business activity qualifies and, if it qualifies, whether it qualifies in whole or in part as Qualifying Production Activity. If some, but not all of your business revenue qualifies, you must be able to identify the qualifying income and separate the Qualifying Production Activity Revenue from non-qualifying revenue. This will avoid difficulties separating the revenues at a later date.

Another major business area that has been granted substantial tax incentives under the Act is the film and television industry. Section 181 of the Act provides in part that taxpayers who invest in qualifying films and television projects whose budgets are not greater than \$15 million may qualify to deduct 100 percent of their investment against ordinary income in the year the money is spent. For television, the budgets can be \$15 million per episode for a maximum of 44 episodes. Qualifying means that 75 percent of the service wages (i.e., salaries and fees) must be paid in the United States. The people who perform the service need not be U.S. citizens. They simply must be paid in the United States for the services they perform. Further, the film or television project cannot be sexually explicit. This relief expires, unless extended, at the end of 2008. The budget can be increased to \$20 million if a significant amount is spent in a low income or depressed areas. Significant is defined as greater than 50 percent. Film also qualifies as Qualifying Production Activity under the manufacturing section 199 of the Act and therefore can have the same percentage of revenue deduction as explained herein. Television does not qualify as Qualifying Production Activity under Section 199.

The American Job Creation Act of 2004 has provided many avenues of benefits and areas of tax relief for individuals and companies. It most definitely has a beneficial impact as to the real estate industry. It is definitely a matter worth talking about with your attorney and accountant.