

QPAD offers tax relief to contractors

By Todd F. Taggart, Minneapolis tax partner

The widely publicized dispute between U.S. lawmakers and other members of the World Trade Organization (WTO) related to U.S. tax incentives for exports came to a resolution of sorts in 2004 with the passage of The American Jobs Creation Act of 2004 (AJCA). Signed into law on Oct. 22, 2004, AJCA has as its centerpiece a new tax deduction appropriately named the “Qualified Production Activity Deduction” or QPAD. Contractors will directly benefit from this new deduction.

One of the interesting characteristics of the QPAD is that it impacts taxpayers that were not part of the dispute between the WTO and the U.S. Congress. Various export incentives, including the Foreign Sales Corporation or the Extraterritorial Income Exclusion, were declared unfair trade practices by the WTO. These tax incentives, now repealed, only benefited taxpayers who sold their products overseas. Contractors rarely benefited from these incentives. The replacement for export incentives, the QPAD, on the other hand, will impact and directly benefit virtually every U.S. contractor.

The QPAD is a deduction from the gross receipts of a taxpayer who has “qualifying activities,” which includes construction performed in the U.S. It is computed as a percentage of income from qualifying activities (subject to certain limitations).

The percentage is phased in over the next six years at 3% for 2005 and 2006, 6% for 2007, 2008 and 2009; and 9% for years after 2009.

The QPAD is available to contractors regardless of their form of organization. Thus, C corporations, S corporations, partnerships and individuals will benefit from the QPAD, beginning in 2005.

As noted above, construction is included in the definition of qualifying activities. The Conference Report to the AJCA defines construction activities as:

“Directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting.”

Recent guidance from the Internal Revenue Service (IRS) clarifies that more than one taxpayer may qualify for the QPAD with respect to the same construction project. For example, a general contractor and a subcontractor will be entitled to a QPAD deduction for the percentage of profit on work performed on a construction project – in other words, for self-performed work.

Contractors will generally allocate costs, for purposes of the QPAD, under the same rules

that they currently use for computing taxable income. For taxpayers with gross receipts of less than \$25 million, a simplified formula is available.

Although the IRS has provided guidance in Notice 2005-14, substantive questions still remain relative to the QPAD. For example, several advisors have urged the IRS to provide a more expansive definition of construction activities by adopting language and concepts currently in effect. Other issues relating to real estate development and the residential construction industry require expanded guidance. The IRS announced on Feb. 22, 2005, that they expect to issue proposed regulations this summer that will clarify statutory language related to construction.

The QPAD deduction is currently in effect and is available to help contractors reduce their tax burden in 2005 and forward. You should contact your Grant Thornton advisor when making 2005 estimated tax or planning for 2005 to ensure you take full advantage of this new deduction.



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