



Documents for Podcast  
What Did They Mean? Construction and §199 Under the Final Regulations  
July 1, 2006



Feed address for Podcast subscription:  
<http://feeds.feedburner.com/EdZollarsTaxUpdate>  
Home page for Podcast: <http://ezollars.libsyn.com>  
©2006 Edward K. Zollars, CPA

*The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.*

*The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.*

*The podcast is sponsored by Leimberg Information Services, located on the web at <http://www.leimbergservices.com>. Leimberg Information Services offers email newsletters on matters of interest to tax practitioners.*

## **Section 199 Final Regulations and Construction**

The IRS in the beginning of June released the final regulations with regard to the Section 199 subtraction based on income from domestic production. An item of interest to many CPAs in local firms will be the definition of just what is “construction” for purposes of these regulations.

With this podcast we also pass the one year mark for the podcast, which launched at the end of June last year shortly after iTunes began supporting podcasts.

*Commentary from the Treasury Decision Announcing the Regulation (TD 9263):*

*Tangible Personal Property and Real Property*

Commentators requested that the final regulations define tangible

personal property and real property for purposes of section 199. The final regulations define tangible personal property as any tangible property other than land, real property described in the construction rules in § 1.199-3(m)(1), computer software described in § 1.199-3(j)(3), sound recordings described in § 1.199-3(j)(4), a qualified film described in § 1.199-3(k)(1), and utilities described in § 1.199-3(l). In response to commentators' suggestions, the final regulations further define tangible personal property as also including any gas (other than natural gas described in § 1.199-3(l)(2)), chemicals, and similar property, for example, steam, oxygen, hydrogen, and nitrogen.

The final regulations define the term real property to mean buildings (including items that are structural components of such buildings), inherently permanent structures (as defined in § 1.263A-8(c)(3)) other than machinery (as defined in § 1.263A-8(c)(4)) (including items that are structural components of such inherently permanent structures), inherently permanent land improvements, oil and gas wells, and infrastructure (as defined in § 1.1993(m)(4)). Property MPGE by a taxpayer that is not real property in the hands of such taxpayer, but that may be incorporated into real property by another taxpayer, is not treated as real property by the producing taxpayer (for example, bricks, nails, paint, and windowpanes). Structural components of buildings and inherently permanent structures include property such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. In addition, an entire utility plant including both the shell and the interior will be treated as an inherently permanent structure.

#### *Construction of Real Property*

One commentator recommended that DPGR derived from the construction of real property as well as DPGR from engineering and architectural services for a construction project include W-2 wages earned as an employee. At the time the taxpayer performs construction activities, or engineering or architectural services, the taxpayer must be engaged in a trade or business that is considered construction, engineering or architectural services for purposes of the North American Industry Classification System (NAICS). W-2 wages earned by an employee are not earned in connection with a trade or business that is considered construction, or engineering or architectural services, for purposes of the NAICS. Consequently, this recommendation has not been adopted in the final regulations.

The proposed regulations include within the definition of construction

services activities relating to drilling an oil well and mining pursuant to which the taxpayer could deduct intangible drilling and development costs under section 263(c) and § 1.612- 4, and development expenditures for a mine or natural deposit under section 616. The IRS and Treasury Department are aware that in many situations taxpayers provide these services with respect to property owned by another party, and therefore such taxpayers are ineligible to claim the deductions for such costs under the provisions described above. The language of the final regulations has been changed to clarify that taxpayers providing such services are engaging in construction services that may qualify under section 199.

The preamble to the proposed regulations states that commentators requested that qualifying construction activities include construction activities related to oil and gas wells. The preamble further states that the proposed regulations provide as a matter of administrative grace that qualifying construction activities include activities relating to drilling an oil well. Similarly, under § 1.199-3(l)(2) of the proposed regulations, construction activities include activities relating to drilling an oil well. A commentator noted the inadvertent omission of gas wells and the final regulations correct the omission.

The proposed regulations provide that DPGR does not include gross receipts attributable to the sale or other disposition of land (including zoning, planning, entitlement costs, and other costs capitalized into the land such as grading and demolition of structures under section 280B). Commentators contended that grading and demolition are construction-related activities, and that gross receipts attributable to these activities should qualify as DPGR. After considering the comments, the IRS and Treasury Department believe it is appropriate to apply to grading and demolition activities the same rule that the proposed regulations apply to other construction activities, such as landscaping and painting. Accordingly, services such as grading, demolition, clearing, excavating, and any other activities that physically transform the land are activities constituting construction only if these services are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property. The IRS and Treasury Department continue to believe that gross receipts attributable to the sale or other disposition of land (including zoning, planning, and entitlement costs) are properly considered gross receipts attributable to the land, not to a qualifying construction activity, and, therefore, are non-DPGR.

In response to a suggestion by a commentator, the final regulations provide that a taxpayer engaged in a construction activity must make a

reasonable inquiry or a reasonable determination whether the activity relates to the erection or substantial renovation of real property in the United States.

The proposed regulations contain an example of an electrical contractor who purchases wires, conduits, and other electrical materials that the contractor installs in construction projects in the United States and that are considered structural components. The example concludes that the gross receipts that the contractor derives from installing these materials are derived from construction, but that the gross receipts attributable to the purchased materials are not. Commentators objected to this result, contending that it places an unreasonable administrative burden on taxpayers performing construction activities. The final regulations, including the example, provide that, in such circumstances, the taxpayer performing the construction services is not required to allocate gross receipts to the purchased materials and treat such gross receipts as non-DPGR, provided the materials and supplies are consumed in the construction project or become part of the constructed real property.

Section 199(c)(4)(A), as amended by the GOZA, requires that a taxpayer be engaged in the active conduct of a construction trade or business for the taxpayer's construction activity to qualify under section 199. The proposed regulations provide that a taxpayer may not treat as DPGR gross receipts derived from construction unless the taxpayer is engaged in a construction trade or business on a regular and ongoing basis. Commentators expressed concern that this requirement would preclude construction project-specific joint ventures or partnerships, a common business structure in the construction industry, from qualifying under section 199. Typically, such entities are formed for the purpose of a specific construction project, and are terminated or dissolved when the project is completed. The final regulations continue to require that a taxpayer be engaged in a regular and ongoing construction trade or business, but provide a safe harbor rule under which entities formed specifically for purposes of a particular construction project may qualify. Under the safe harbor rule, if a taxpayer is engaged in a construction trade or business, then the taxpayer will be considered to be engaged in such trade or business on a regular and ongoing basis if the taxpayer derives gross receipts from an unrelated person by selling or exchanging the constructed real property within 60 months of the date on which construction is complete.

Commentators also expressed concern that taxpayers would not meet the requirement of being engaged in a construction business on a regular and ongoing basis if the taxpayer is newly-formed or otherwise is in the

first taxable year of a new construction trade or business. Although some taxpayers may meet the regular-and-ongoing- business requirement under the safe harbor rule discussed previously, the final regulations provide that, in the case of a newly-formed trade or business or a taxpayer in its first taxable year, the taxpayer will satisfy the regular-and-ongoing-basis requirement if it reasonably expects to be engaged in a construction trade or business on a regular and ongoing basis.

The IRS and Treasury Department received a comment requesting clarification of the land safe harbor of § 1.199-3(l)(5)(ii) of the proposed regulations. Under the land safe harbor, the taxpayer is permitted to allocate gross receipts between real property other than land, and land, according to a formula. The taxpayer must reduce gross receipts by the costs of the land and any other costs capitalized to the land, plus a percentage of those costs, and costs related to DPGR must be reduced by the costs of the land and any other costs capitalized to the land. The percentage ranges from 5 to 15 percent, depending upon the length of time the taxpayer held the land. The commentator asked whether the holding period of a previous owner of the land would be attributed to the new owner, and what rules apply for purposes of computing the new owner's cost basis. Generally, if an existing provision of the Code or regulations would apply to require attribution of the holding period of a previous owner of property to a new owner, the same rules will apply in the case of a previous owner's holding period in land for purposes of the land safe harbor rule of section 199. For example, the holding period of the previous owner (P) would carry over to the new owner (N) under existing Federal income tax principles if P were a partner in partnership N, and P contributed the land to N. The same result would apply if, instead, the land was distributed by partnership P to N, its partner. In the case of partnership or other pass-thru entity, the land safe harbor is applied at the partnership or other pass-thru entity level and is not applied at the partner or owner level.

With regard to the land safe harbor discussed in the preceding paragraph, the proposed regulations state that the length of time a taxpayer is deemed to hold the land begins on the date the taxpayer acquires the land, including the date the taxpayer enters into the first option to acquire all or a portion of the land, and ends on the date the taxpayer sells each item of real property on the land. Commentators stated that development of the land generally does not begin until the land is acquired and any option to acquire land is based on the land's fair market value. Because developers are paying fair market value, the commentators suggested that the period for determining the percentage

should not include any option period. The IRS and Treasury Department generally agree with the commentator's suggestion, and the final regulations do not include the option period except where the option does not include provisions to adjust the purchase price to approximate fair market value.

*Example 1* in § 1.199-3(m)(5)(iii) of the proposed regulations provides that X, who is in a construction trade or business under NAICS Code 23 on a regular and ongoing basis, purchases a building and retains Y, a general contractor, to perform construction services in connection with a substantial renovation of the building. The example concludes that X's gross receipts derived from the disposition of the building are non-DPGR, and that Y's gross receipts from amounts paid to it by X are DPGR. In addition, the example illustrates that gross receipts of subcontractors hired by Y qualify as DPGR. Some commentators inferred from this example that the taxpayer must, at a minimum, be a legally designated general contractor before its gross receipts may qualify as DPGR. The example was not intended to imply that a taxpayer must be a licensed general contractor. The final regulations clarify that activities constituting construction include activities typically performed by a general contractor, or that constitute general contractor-level work, such as activities relating to management and oversight of the construction process (for example, approvals, periodic inspection of the progress of the construction project, and required job modifications). The example has been modified in the final regulations to illustrate that the person hired by the building owner, although not a licensed general contractor, qualifies as engaging in construction activities by virtue of providing management and oversight of the construction process.

Several commentators recommended that the final regulations provide that, for purposes of the de minimis exception of § 1.199-3(l)(5)(ii) (regarding construction services), gross receipts attributable to land be disregarded for purposes of calculating the de minimis exception. In response to the comments, the final regulations clarify that, if a taxpayer applies the land safe harbor, then the gross receipts excluded under the land safe harbor are excluded in determining total gross receipts under the de minimis exception. The final regulations also provide that, if a taxpayer does not apply the land safe harbor and uses any reasonable method (for example, an appraisal of the land) to allocate gross receipts attributable to the land to non-DPGR, then a taxpayer applies the de minimis exception by excluding such gross receipts derived from the sale, exchange, or other disposition of the land from total gross receipts.

A commentator requested that the definition of construction activities not

be limited to direct activities and should include services incidental to the performance of such activities. As an administrative convenience, the final regulations provide that construction activities include certain administrative support services such as billing and secretarial services performed by the taxpayer. The final regulations provide a similar rule for engineering and architectural services.

### **Regulation §1.199-3(m)**

(m) Definition of construction performed in the United States

(1) Construction of real property

(i) In general.

The term construction means activities and services relating to the construction or erection of real property (as defined in paragraph (m)(3) of this section) in the United States by a taxpayer that, at the time the taxpayer constructs the real property, is engaged in a trade or business (but not necessarily its primary, or only, trade or business) that is considered construction for purposes of the North American Industry Classification System (NAICS) on a regular and ongoing basis. A trade or business that is considered construction under the NAICS means a construction activity under the two-digit NAICS code of 23 and any other construction activity in any other NAICS code provided the construction activity relates to the construction of real property such as NAICS code 213111 (drilling oil and gas wells) and 213112 (support activities for oil and gas operations). For purposes of this paragraph (m), the term construction project means the construction activities and services treated as the item under paragraph (d)(2)(iii) of this section. Tangible personal property (for example, appliances, furniture, and fixtures) that is sold as part of a construction project is not considered real property for purposes of this paragraph (m)(1)(i). In determining whether property is real property, the fact that property is real property under local law is not controlling. Conversely, property may be real property for purposes of this paragraph (m)(1)(i) even though under local law the property is considered tangible personal property.

(ii) Regular and ongoing basis

(A) In general.

For purposes of paragraph (m)(1)(i) of this section, a taxpayer engaged in a construction trade or business will be

considered to be engaged in such trade or business on a regular and ongoing basis if the taxpayer derives gross receipts from an unrelated person by selling or exchanging the constructed real property described in paragraph (m)(3) of this section within 60 months of the date on which construction is complete (for example, on the date a certificate of occupancy is issued for the property).

(B) New trade or business.

In the case of a newly-formed trade or business or a taxpayer in its first taxable year, the taxpayer is considered to be engaged in a trade or business on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in a trade or business on a regular and ongoing basis.

(iii) De minimis exception

(A) DPGR.

For purposes of paragraph (m)(1)(i) of this section, if less than 5 percent of the total gross receipts derived by a taxpayer from a construction project (as described in paragraph (m)(1)(i) of this section) are derived from activities other than the construction of real property in the United States (for example, from non-construction activities or the sale of tangible personal property or land), then the total gross receipts derived by the taxpayer from the project may be treated as DPGR from construction. If a taxpayer applies the land safe harbor under paragraph (m)(6)(iv) of this section, for a construction project (as described in paragraph (m)(1)(i) of this section), then the gross receipts excluded under the land safe harbor are excluded in determining total gross receipts under this paragraph (m)(1)(iii)(A). If a taxpayer does not apply the land safe harbor and uses any reasonable method (for example, an appraisal of the land) to allocate gross receipts attributable to the land to non-DPGR, then a taxpayer applies this paragraph (m)(1)(iii)(A) by excluding such gross receipts derived from the sale, exchange, or other disposition of the land from total gross receipts. In the case of gross receipts derived from construction that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be

derived) from construction. For purposes of the preceding sentence, if a taxpayer treats gross receipts as DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as DPGR.

(B) Non-DPGR.

For purposes of paragraph (m)(1)(i) of this section, if less than 5 percent of the total gross receipts derived by a taxpayer from a construction project qualify as DPGR, then the total gross receipts derived by the taxpayer from the construction project may be treated as non-DPGR. In the case of gross receipts derived from construction that are received over a period of time (for example, an installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from construction. For purposes of the preceding sentence, if a taxpayer treats gross receipts as non-DPGR under this de minimis exception, then the taxpayer must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(2) Activities constituting construction

(i) In general.

Activities constituting construction are activities performed in connection with a project to *erect or substantially renovate* real property, including activities performed by a general contractor or that constitute activities typically performed by a general contractor, for example, 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.

(ii) Tangential services.

Activities constituting construction do not include tangential services such as hauling trash and debris, and delivering materials, even if the tangential services are essential for construction. However, if the taxpayer performing construction also, in connection with the construction project, provides tangential services such as delivering materials to the construction site and removing its construction debris, then the gross receipts derived from the tangential services are DPGR.

(iii) Other construction activities.

Improvements to land that are not capitalizable to the land (for example, landscaping) and painting are activities constituting construction only if these activities are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property and provided the taxpayer meets the requirements under paragraph (m)(1) of this section. Services such as grading, demolition (including demolition of structures under section 280B), clearing, excavating, and any other activities that physically transform the land are activities constituting construction only if these services are performed in connection with other activities (whether or not by the same taxpayer) that constitute the erection or substantial renovation of real property and provided the taxpayer meets the requirements under paragraph (m)(1) of this section. A taxpayer engaged in these activities must make a reasonable inquiry or a reasonable determination as to whether the activity relates to the erection or substantial renovation of real property in the United States. Construction activities also include activities relating to drilling an oil or gas well and mining and include any activities the cost of which are intangible drilling and development costs within the meaning of § 1.612-4 or development expenditures for a mine or natural deposit under section 616.

(iv) Administrative support services.

If the taxpayer performing construction activities also provides, in connection with the construction project, administrative support services (for example, billing and secretarial services) incidental and necessary to such construction project, then these administrative support services are considered construction activities.

(v) Exceptions.

The lease, license, or rental of equipment, for example, bulldozers, generators, or computers, for use in the construction of real property is not a construction activity under this paragraph (m)(2). The term construction does not include any activity that is within the definition of engineering and architectural services under paragraph (n) of this section.

(3) Definition of real property.

The term real property means buildings (including items that are

structural components of such buildings), inherently permanent structures (as defined in § 1.263A-8(c)(3)) other than machinery (as defined in § 1.263A-8(c)(4)) (including items that are structural components of such inherently permanent structures), inherently permanent land improvements, oil and gas wells, and infrastructure (as defined in paragraph (m)(4) of this section). For purposes of the preceding sentence, an entire utility plant including both the shell and the interior will be treated as an inherently permanent structure. Property produced by a taxpayer that is not real property in the hands of that taxpayer, but that may be incorporated into real property by another taxpayer, is not treated as real property by the producing taxpayer (for example, bricks, nails, paint, and windowpanes). For purposes of this paragraph (m)(3), structural components of buildings and inherently permanent structures include property such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property.

(4) Definition of infrastructure.

The term infrastructure includes roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, and wiring. The term also includes inherently permanent oil and gas platforms.

(5) *Definition of substantial renovation.*

*The term substantial renovation means the 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.*

(6) Derived from construction

(i) In general.

Assuming all the requirements of this section are met, DPGR derived from the construction of real property performed in the United States includes the proceeds from the sale, exchange, or other disposition of real property constructed by the taxpayer in the United States (whether or not the property is sold immediately after construction is completed and whether or not the construction project is completed). DPGR derived from the construction of real property includes compensation for the performance of construction services by the taxpayer in the United States. DPGR derived from the construction of real property includes gross receipts derived from materials and supplies consumed in the construction project or that become part of the constructed real property, assuming all the

requirements of this section are met.

(ii) Qualified construction warranty.

DPGR derived from the construction of real property includes gross receipts from any qualified construction warranty, that is, a warranty that is provided in connection with the constructed real property if, in the normal course of the taxpayer's business --

(A) The price for the construction warranty is not separately stated from the amount charged for the constructed real property; and

(B) The construction warranty is neither separately offered by the taxpayer nor separately bargained for with customers (that is, the customer cannot purchase the constructed real property without the construction warranty).

(iii) Exceptions.

DPGR derived from the construction of real property performed in the United States does not include gross receipts derived from the sale, exchange, or other disposition of real property acquired by the taxpayer even if the taxpayer originally constructed the property. In addition, DPGR derived from the construction of real property does not include gross receipts from the lease or rental of real property constructed by the taxpayer or, except as provided in paragraph (m)(2)(iii) of this section, gross receipts derived from the sale or other disposition of land (including zoning, planning, entitlement costs, and other costs capitalized to the land).

(iv) Land safe harbor

(A) In general.

For purposes of paragraph (m)(6)(i) of this section, a taxpayer may allocate gross receipts between the gross receipts derived from the sale, exchange, or other disposition of real property constructed by the taxpayer and the gross receipts derived from the sale, exchange, or other disposition of land by reducing its costs related to DPGR under § 1.199-4 by the costs of the land and any other costs capitalized to the land (collectively, land costs) (including zoning, planning, entitlement costs, and other costs capitalized to the land (except costs for activities listed in paragraph (m)(2)(iii) of this section) and land costs in any

common improvements as defined in section 2.01 of Rev. Proc. 92-29 (1992-1 C.B. 748) (see § 601.601(d)(2) of this chapter)) and by reducing its DPGR by those land costs plus a percentage. Generally, the percentage is based on the number of months that elapse between the date the taxpayer acquires the land (not including any options to acquire the land) and ends on the date the taxpayer sells each item of real property on the land. However, a taxpayer will be deemed, for purposes of this paragraph (m)(6)(iv)(A), to acquire the land on the date the taxpayer entered into an option agreement to acquire the land if the taxpayer acquired the land pursuant to such option agreement and the purchase price of the land under the option agreement does not approximate the fair market value of the land. In the case of a sale or disposition of land between related persons (as defined in paragraph (b)(1) of this section) for less than fair market value, for purposes of determining the percentage, the purchaser or transferee of the land must include the months during which the land was held by the seller or transferor. The percentage is 5 percent for land held not more than 60 months, 10 percent for land held more than 60 months but not more than 120 months, and 15 percent for land held more than 120 months but not more than 180 months. Land held by a taxpayer for more than 180 months is not eligible for the safe harbor under this paragraph (m)(6)(iv)(A).

(B) Determining gross receipts and costs.

In the case of a taxpayer that uses the small business simplified overall method of cost allocation under § 1.199-4(f), gross receipts derived from the sale, exchange, or other disposition of land, and costs attributable to the land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, are not taken into account for purposes of computing QPAI under §§ 1.199-1 through 1.199-9 except that the gross receipts are taken into account for determining eligibility for that method of cost allocation. All other taxpayers must treat the gross receipts derived from the sale, exchange, or other disposition of land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, as non-DPGR. In the case of a pass-thru entity, if the pass-thru entity would be eligible to

use the small business simplified overall method of cost allocation if the method were applied at the pass-thru entity level, then the gross receipts derived from the sale, exchange, or other disposition of land, and costs allocated to the land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, are not taken into account by the pass-thru entity or its owner or owners for purposes of computing QPAI under § 1.199-1 through 1.199-9. For purposes of the preceding sentence, in determining whether the pass-thru entity would be eligible for the small business simplified overall method of cost allocation, the gross receipts excluded pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section are taken into account for determining eligibility for that method of cost allocation. All other pass-thru entities (including all trusts and estates described in § 1.199-9(e)) must treat the gross receipts attributable to the sale, exchange, or other disposition of land, pursuant to the land safe harbor under paragraph (m)(6)(iv)(A) of this section, as non-DPGR.

(v) Examples.

The following examples illustrate the application of this paragraph (m)(6):

Example 1. A, who is in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, purchases a building in the United States and retains B, an unrelated person, to oversee a substantial renovation of the building (within the meaning of paragraph (m)(5) of this section). Although not licensed as a general contractor, B performs general contractor 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. B retains C (a general contractor) to oversee day-to-day operations and hire subcontractors. C hires D (a subcontractor) to install a new electrical system in the building as part of that substantial renovation. The amounts that B receives from A for construction services, the amounts that C receives from B for construction services, and the amounts that D receives from C for construction services qualify as DPGR under paragraph (m)(6)(i) of this section provided B, C, and D meet all of the requirements of paragraph (m)(1) of this section. The gross receipts that A receives

from the subsequent sale of the building do not qualify as DPGR because A did not engage in any activity constituting construction under paragraph (m)(2) of this section even though A is in the trade or business of construction. The results would be the same if A, B, C, and D were members of the same EAG under § 1.199-7(a). However, if A, B, C, and D were members of the same consolidated group, see § 1.199-7(d)(2).

Example 2. X is engaged as an electrical contractor under NAICS code 238210 on a regular and ongoing basis. X purchases the wires, conduits, and other electrical materials that it installs in construction projects in the United States. In a particular construction project, all of the wires, conduits, and other electrical materials installed by X for the operation of that building are considered structural components of the building. X's gross receipts derived from installing that property are derived from the construction of real property under paragraph (m)(1) of this section. In addition, pursuant to paragraph (m)(6)(i) of this section, X's gross receipts derived from the purchased materials qualify as DPGR because the wires, conduits, and other electrical materials are consumed during the construction of the building or become structural components of the building.

Example 3. X is engaged in a trade or business on a regular and ongoing basis that is considered construction under the two-digit NAICS code of 23. X buys unimproved land in the United States. X gets the land zoned for residential housing through an entitlement process. X grades the land and sells the land to home builders who construct houses on the land. The gross receipts that X derives from the sale of the land that are attributable to the grading qualify as DPGR under paragraphs (m)(2)(iii) and (6)(i) of this section because those services are undertaken in connection with a construction project in the United States. X's gross receipts derived from the land including capitalized costs of entitlements (including zoning) do not qualify as DPGR under paragraph (m)(6)(i) of this section because the gross receipts are not derived from the construction of real property.

Example 4. The facts are the same as in Example 3 except that X constructs roads, sewers, and sidewalks, and installs power and water lines on the land. X conveys the roads, sewers, sidewalks, and power and water lines to the local government and utilities. The gross receipts that X derives from the sale of lots that are

attributable to grading, and the construction of the roads, sewers, sidewalks, and power and water lines (that qualify as infrastructure under paragraph (m)(4) of this section) are DPGR. X's gross receipts derived from the land including capitalized costs of entitlements (including zoning) do not qualify as DPGR under paragraph (m)(6)(i) of this section because the gross receipts are not derived from the construction of real property.

Example 5. (i) Facts. X, who is engaged in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, constructs housing that is real property under paragraph (m)(3) of this section. On June 1, 2007, X pays \$50,000,000 and acquires 1,000 acres of land that X will develop as a new housing development. In November 2007, after the expenditure of \$10,000,000 for entitlement costs, X receives permits to begin construction. After this expenditure, X's land costs total \$60,000,000. The development consists of 1,000 houses to be built on half-acre lots over 5 years. On January 31, 2012, the first house is sold for \$300,000. Construction costs for each house are \$170,000. Common improvements consisting of streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools that X is contractually obligated or required by law to provide cost \$55,000 per lot. The common improvements of \$55,000 per lot include \$30,000 in land costs underlying the common improvements.

(ii) Land safe harbor. Pursuant to the land safe harbor under paragraph (m)(6)(iv) of this section, X calculates the basis for each house sold as \$195,000 (total costs of \$255,000 (\$170,000 in construction costs plus \$55,000 in common improvements (including \$30,000 in land costs) plus \$30,000 in land costs for the lot), which are reduced by land costs of \$60,000). X calculates the DPGR for each house sold by taking the gross receipts of \$300,000 and reducing that amount by land costs of \$60,000 plus a percentage of \$60,000. As X acquired the land on June 1, 2007, for each house sold on the land between January 31, 2012, and June 1, 2012, the percentage reduction for X is 5% because X has held the land for not more than 60 months from the date of acquisition. Thus, X's DPGR for each house is \$237,000 (\$300,000 - \$60,000 - \$3,000) with costs for each house of \$195,000 (\$255,000 - \$60,000). For each house sold on the land between June 2, 2012 and June 1, 2017, the percentage reduction for X is 10% because X has held the land for more than 60 months but not more than 120

months from the date of acquisition. Thus, of the \$300,000 of gross receipts, X's DPGR for each house is \$234,000 (\$300,000 - \$60,000 - \$6,000) with costs for each house of \$195,000 (\$255,000 - \$60,000).

Example 6. The facts are the same as in Example 5 except that on December 31, 2007, after X received the permits to begin construction, X sold the entitled land to Y, an unrelated corporation, for \$75,000,000. Y is engaged in a trade or business on a regular and ongoing basis that is considered construction under NAICS code 23. Y subsequently incurred the construction costs and the costs of the common improvements, and Y sold the houses. Because X did not perform any construction activities, none of X's \$75,000,000 in gross receipts derived from Y are DPGR and none of X's costs are allocable to DPGR. Pursuant to the land safe harbor under paragraph (m)(6)(iv) of this section, Y calculates the basis for each house sold as \$195,000 (total costs of \$270,000 (\$170,000 in construction costs plus \$62,500 in common improvements (including \$37,500 in land costs) plus \$37,500 in land costs for the lot), which are reduced by land costs of \$75,000). Y calculates the DPGR for each house sold by taking the gross receipts of \$300,000 and reducing that amount by land costs of \$75,000 plus a percentage of \$75,000. As Y acquired the land on December 31, 2007, for the houses sold on the land between January 31, 2012, and December 31, 2012, the percentage reduction for Y is 5% because Y held the land for not more than 60 months from the date of acquisition. Thus, of the \$300,000 of gross receipts, the DPGR for each house is \$221,250 (\$300,000 - \$75,000 - \$3,750) with costs for each house of \$195,000. For the houses sold on the land between January 1, 2013, and December 31, 2017, the percentage reduction for Y is 10% because Y held the land for more than 60 months but not more than 120 months from the date of acquisition. Thus, of the \$300,000 of gross receipts, the DPGR for each house is \$217,500 (\$300,000 - \$75,000 - \$7,500) with costs for each house of \$195,000. The results would be the same if X and Y were members of the same EAG, provided X and Y were not members of the same consolidated group.

Example 7. The facts are the same as in Example 6 except that Y is a member of the same consolidated group as X. Pursuant to § 1.1502-13(c)(1)(ii), Y's holding period in the land includes the period of time X held the land. In order to produce the same effect as if X and Y were divisions of a single corporation (see § 1.1502-

13(c)(1)(i), for each house sold between January 31, 2012, and June 1, 2012, Y's DPGR are redetermined to be \$237,000, the same as X's DPGR for houses sold between January 31, 2012, and June 1, 2012, in Example 5. Y's costs for each house do not have to be redetermined because Y's costs are \$195,000, the same as the costs would be if X and Y were divisions of a single corporation. For each house sold between June 2, 2012, and June 1, 2017, Y's DPGR are redetermined to be \$234,000, the same as X's DPGR for each house sold between June 2, 2012, and June 1, 2017, in Example 5. Y's costs for each house do not have to be redetermined because Y's costs are \$195,000, the same as the costs would be if X and Y were divisions of a single corporation.

Example 8. X, who is engaged in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, purchases land for development and builds an office building on the land. Y enters into a contract with X to purchase the office building. As part of the contract, X is required to furnish the office space with desks, chairs, and lamps. Upon completion of the sale of the building, X uses the land safe harbor under paragraph (m)(6)(iv) of this section to account for the land. After application of the land safe harbor, X uses the de minimis exception under paragraph (m)(1)(iii)(A) of this section in determining whether the gross receipts derived from the sale of the desks, chairs, and lamps qualify as DPGR. If the gross receipts derived from the sale of the desks, chairs, and lamps are less than 5% of the total gross receipts derived by X from the sale of the furnished office building (excluding any gross receipts taken into account under the land safe harbor pursuant to paragraph (m)(6)(iv)(B) of this section), then all of the gross receipts derived from the sale of the furnished office building, after the reduction under the land safe harbor, may be treated as DPGR.