

Deduction Offers Advantages to Manufacturers

For many years the Federal government has enacted legislation mandating some relief from taxes on income generated from exports. Not until the beginning of 2005, however, have such benefits been available to manufacturers and other producers, with only domestic sales.

Prior to 1985, the Domestic International Sales Corporations (DISC) law applied. It provided for the deferral of taxation on income generated from the sale of exported products. It was interpreted, however, as possibly being an illegal export subsidy, so the law was replaced by the Foreign Sales Corporation law (FSC) in 1985. This law provided that a portion of foreign sales income was exempt from U.S. taxation. The World Trade Organization (WTO) deemed this to be an illegal export subsidy, so again the law was replaced, this time by the Extraterritorial Income Exclusion (ETI). ETI was also judged by the World Trade Association to be an illegal subsidy, but congress took no action until the WTO imposed sanctions on U.S. exports. These sanctions amounted to a penalty of a 12% surcharge on exports, and the penalty was to be increased by 1% per month. Under this pressure Congress responded with the "Manufacturing Deduction."

The deduction applies to the following areas of production:

1. Traditional manufacturing
2. Construction
3. Engineering
4. Energy production
5. Computer software
6. Films and videotape
7. Processing of agricultural products.

The manufacturing deduction will be phased in over the period from 2005 to 2010. In 2005 and 2006 the rate of the deduction applied to income will be 3%; in 2007, 2008 and 2009 it will be 6%, and in 2010 and thereafter it will be 9%.

The deduction will be applied to the lesser of income from qualified activities or the taxable income for the year. The deduction is also limited to 50% of the W2 wages paid for the year.

Virtually every type of entity is eligible including C corporations, Individuals, S corporations, Partnerships, Estates and Trusts, and Cooperatives.

The calculation of income eligible for the deduction subtracts related expenses from qualifying revenues. Qualifying revenues are gross receipts from tangible personal property that was manufactured, produced, grown, or extracted and that was derived from any lease, rental, license, sale, exchange or other disposition.

The allocation of expenses to calculate qualifying income includes the cost of goods sold which are directly allocable to qualifying gross receipts. It also can consist of other deductions, expenses or losses directly allocable to these receipts. In addition, a reasonable ratable portion of deductions, expenses and losses that are not directly related to the qualifying gross receipts, or to another class of income, is allocable.

The IRS acknowledges in Notice 2005-14 that no single method of allocation would be applicable to all taxpayers, and therefore no single method is mandated. The IRS does require that the method be reasonable and that once a method has been established, it be applied consistently from year to year. The method must also utilize as sophisticated information as is available to the taxpayer. For example, if the taxpayer's accounting system allocates costs directly to specific products, these allocations must be used.

For companies with \$25,000,000 or less of gross receipts, expense allocations *other than the cost of goods sold* may be determined as a ratio of qualifying gross receipts to non-qualifying gross receipts. For companies with gross receipts of less than \$5,000,000, *all expenses* may be allocated as a ratio of qualifying gross receipts to non-qualifying gross receipts.

The benefits of these new deductions can be considerable. For companies in the 33% income tax bracket, 3% of taxes could be saved in 2005 and as much as 9% by 2010.

---Robert M. Power, Jr., CPA, CVA, ABV, CSMC

Editor's Note --- Bob is a Partner in the firm who splits his time between the firm's Erie and Meadville offices. He has a career of providing services to manufacturing clients and is a Certified Specialist in Management Consulting by the NIEPE. Bob is also a specialist in business valuations and litigation services and is a Certified Valuation Analyst by the NACVA and is Accredited in Business Valuation by the AICPA.