

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,

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(Deduction continued)

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.



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“Incentives for Research and Development”

Does your company design and develop new products or processes? Is there uncertainty at the outset of the project? If you answered yes to these questions, you may qualify for some substantial federal and state tax credits. These credits will reduce dollar for dollar your income tax liability.

Basically, the federal credit is equal to 20% of the qualified research expenditures for the current year in excess of a base amount. The company's deduction for expenses related to R&D must be reduced by the amount of the credit, unless the company elects to take a credit of 13%, rather than 20%.

In order to qualify for the credit, the research activity must be undertaken for the purpose of discovering information that is technological in nature and is paid in connection with carrying out the trade or business of the taxpayer. Furthermore, the research must be conducted utilizing a process of experimentation.

In December of 2003 final regulations were released. This new guidance significantly expands the expenditures that qualify for the credits and provides us with greater opportunities in this area. As part of these final regulations the process of experimentation was more clearly defined. These requirements are:

1. The process must evaluate at least one alternative.
2. There must be uncertainty related to the result or outcome.
3. The process of experimentation must rely on fundamental principles of the physical or biological sciences, engineering or computer science to resolve the uncertainty.
4. Methodologies may involve modeling, simulation or systematic trial and error.

Qualified research and experimentation expenditures include taxable wages for qualified services performed in support of the research, the amount paid for supplies used in the conduct of the qualified research and 65% of all contracted research expenses. The key is identifying eligible research wages. It is not unusual for engineers and top level management to spend substantial time in direct services and supervision of research projects. The research has to be conducted in the United States before the commercial introduction of a product on the market and it cannot involve style, taste, cosmetic design, or seasonal design factors.

Many activities that you are currently performing within your company simply to maintain a competitive edge may in fact qualify for this credit. The following is a listing of some types of activities where this opportunity for substantial tax credits may occur:

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1. Develop new, improved or more reliable products, processes or formulas.
2. Design tools, jigs, molds and dies.
3. Develop or apply for patents.
4. Streamline or automate internal processes.
5. Develop new technology.
6. Utilize new materials in your manufactured product.
7. Develop or upgrade production control or systems software.
8. Perform environmental or certification testing.
9. Develop models or prototypes.
10. Add new equipment or build or improve a new manufacturing facility.
11. Contract with outside consultants to perform any of these above listed activities.

While under current law this credit is scheduled to expire at the end of this year, there is a current proposal, entitled the "Investment in America Act of 2005" that would permanently extend the credit. It would also add an "elective alternative simplified credit" based on 12% of the increase in expenditures for research, with the basis being the average research expenditures of the prior three years.

If your company does engage in R&D activities, make sure that you are receiving the tax incentives that are available to give your company the additional reward that it deserves.

---Karen L. Benson, CPA, PFS

Editor's Note --- This article is derived from a presentation that Karen recently made in Erie, Ridgeway and Hermitage to manufacturing companies.



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