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## American Jobs Creation Act of 2004

**New tax relief for manufacturers selling abroad or in the US**

## Historical background

The United States has long provided export-related benefits under its income tax law. For most of the last two decades, these benefits were provided under the foreign sales corporation (FSC) rules. In 2000, the European Union succeeded in having the FSC statutes dismantled by a World Trade Organization (WTO) decision that the structure of the FSC caused it to be an illegal trade subsidy. In response, the United States repealed the FSC rules in 2000 and enacted a new regime known as the Extraterritorial Income Exclusion Act of 2000.

Because of perceived similarities to the FSC regime, the European Union immediately challenged the extraterritorial income (ETI) regime in the WTO. In January 2002, the WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements and demanded its repeal by the U.S. Congress. Congress's failure to act in a timely fashion led to the imposition of an incremental trade tariff on U.S. exports beginning in March 2004 at 5 percent and increasing 1 percent each month. By October 2004, the tariff rate had increased to 12 percent.

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (AJCA), repealing the ETI exclusion and enacting provisions that address several focus areas of the economy. AJCA includes provisions that allow domestic manufacturers a tax benefit through a deduction of a portion of their profit. The AJCA also continues another export tax regime that is now useful for many midsized companies.

## Overview of the Extraterritorial Income Exclusion

The ETI creates a permanent reduction of federal taxable income by the greatest of:

- 1.2 percent of qualifying export receipts
- 15 percent of qualifying export net income
- 30 percent of qualifying export "foreign sale and leasing income"

Each of these three methods can be computed with respect to each separate qualifying export transaction.

## Repeal of the Extraterritorial Income Exclusion

The new law repeals the ETI exclusion for all transactions after December 31, 2004. However, transition provisions included in the law allow modified ETI benefits for transactions occurring after 2004 through 2006.

The transition rules allow taxpayers to compute the ETI exclusion for qualifying exports made in 2005 and 2006 using today's law and then reduce the deduction by 20 percent in 2005 and 40 percent in 2006.

## Planning for repeal and transition

A prospective repeal date and transition rules provide taxpayers with an opportunity to plan for repeal.

The logical questions taxpayers are asking are:

- How will these changes affect my company's tax bill?
- Is there anything my company must do now to avoid a tax increase next year?
- Is there any planning my company can do in the future to obtain full benefits under the new rules?

### **The current ETI exclusion rules apply to all eligible transactions through December 31, 2004.**

*Taxpayers need to assess their opportunities immediately to accelerate qualifying transactions into 2004. A quick cost-benefit analysis can assist an organization in determining what measures should be taken and resources allocated to accelerate sales.*

*Furthermore, taxpayers need to assess whether expenses generally associated with export transactions can be deferred until a subsequent period. Again, a quick cost-benefit analysis can assist an organization in this decision.*

*Alternatively, some taxpayers may wish to defer export profits until 2005 or 2006 in connection with a second export tax-planning opportunity discussed later in this paper.*

**The continuation of current ETI exclusion rules, subject to limitation in 2005 and 2006, compels taxpayers to assess whether they are maximizing their ETI benefits.**

*Many midsized companies fail to optimize their computations of ETI benefits. Minor modifications or slight additions to a taxpayer's international activities can create an opportunity to utilize alternative computation methods and recognize potentially significant additional savings.*

*Assessing and implementing actions prior to the end of 2004 can capture the increased benefits at full exclusion. Continuing these activities into 2005 and 2006 will help maximize ETI benefits through the transition period.*

- Export company pays IC-DISC a commission. Tax law dictates the size of the commission based on the amount of profits from export transactions.
- Export company deducts commission from ordinary income taxed at up to 35 percent (federal).
- IC-DISC, a federally tax-exempt corporation, does not pay tax on the commission.
- Individual shareholders pay income tax on dividends from IC-DISC at a maximum rate of 15 percent.
- Result is a 20 percent tax savings on commission (35 minus 15).

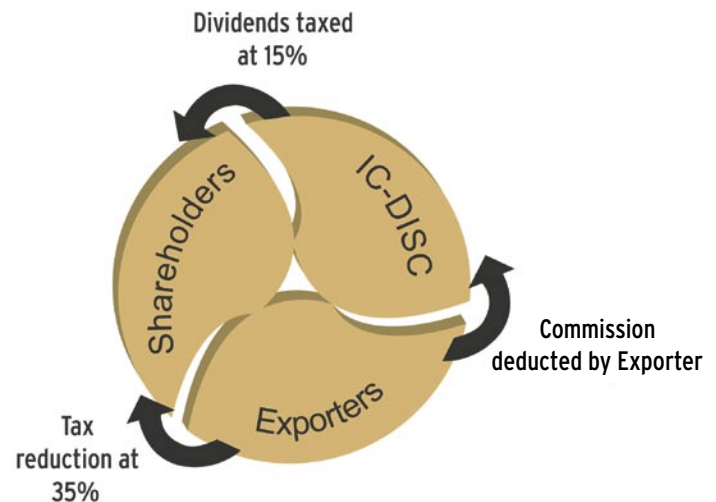
## Alternative Export Incentive Opportunities

Repeal of the ETI exclusion does not eliminate tax benefits for US exporters. The IC-DISC – Interest Charge-Domestic International Sales Corporation – remains available and in some cases may provide tax savings in excess of the ETI exclusion. The white paper, "IC-DISC – Permanent tax savings and more for owner-managed exporting businesses," provides a fuller discussion of this topic. However, the following is a brief summary of the IC-DISC and its benefits.

### How an IC-DISC works

*Implementation of an IC-DISC provides up to a 20 percent permanent tax rate savings on qualifying export income.*

- Owner-managed export company creates a tax-exempt IC-DISC owned by the company or by its individual owners.



## New tax relief for manufacturers selling abroad or in the US

Unaddressed by AJCA is the potential of whether a taxpayer may implement an IC-DISC while utilizing ETI transition benefits. Consensus among advisors and commentators is that the absence of direct guidance provides taxpayers the opportunity to explore utilization of an IC-DISC and ETI transition benefits on a case-by-case basis.

The following example illustrates a business-friendly interpretation of how ETI transition benefits and utilization of an IC-DISC can reduce a midsized manufacturer's tax bill. All amounts are shown in dollars.

Qualifying export receipts		20,000,000	
Cost of goods sold		(16,000,000)	
Gross margin		4,000,000	
Selling, general and administrative costs allocable to export transactions		(3,000,000)	
Export sales net income		1,000,000	
ETI transition benefits (greatest of):			
1.2% of foreign trading gross receipts	240,000		
15% of foreign trade income	150,000		
30% of foreign sale and leasing income	-0-		
Extraterritorial income exclusion	240,000		
2005 transition limitation	20.00%	192,000	
Federal tax savings (35%)		67,200	
IC-DISC commission (greater of):			
50% of export net income	500,000		
4% of export gross receipts	800,000		
IC-DISC commission		800,000	
Federal tax savings (35%)		280,000	
IC-DISC dividend paid out to individual shareholders			800,000
Federal tax (cost) (15%)			(120,000)
Net tax savings – IC-DISC and ETI transition		67,200 + 280,000 - 120,000	227,200
Federal tax without export tax benefits		350,000	
Federal tax using IC-DISC and ETI regimes		122,800	

## Domestic manufacturing activity deduction

Included in AJCA is a new deduction focused on United States-based manufacturing and production. The new provisions allow a deduction from taxable income that is equal to a portion of the taxpayer's qualified production activities income.

## Qualified production activities income

"Qualified production activities income" is equal to domestic production gross receipts, minus:

- Allocable costs of goods sold
- Directly allocable deductions, expenses or losses
- A proper share of indirectly allocable deductions, expenses and losses

In the law, Congress instructs the Secretary of the Treasury to prescribe rules for computing direct and indirect allocable expenses. The rules are expected to be similar and consistent with relevant present-law rules.

For example, other deductions, expenses or losses that are directly allocable to receipts include selling and marketing expenses. Indirect expenses include general and administrative expenses allocable to selling and marketing expenses.

## Domestic production gross receipts

"Domestic production gross receipts" include:

- Any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States
- Any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer
- Any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer

- Construction activities performed in the United States
- Engineering or architectural services performed in the United States for construction projects located in the United States

Some specific activities not eligible for the deduction include:

- Sale of food or beverages prepared by the taxpayer at a retail establishment
- Transmission or distribution of electricity, natural gas or potable water
- Lease, license or rental of property for use by any related person

The committee reports instruct that the following activities are included in domestic production gross receipts:

- The sale, exchange or other disposition of *agricultural products* with respect to which the taxpayer performs storage, handling or other processing activities, provided the products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property – whether or not by the taxpayer.
- *Construction activities* directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure – cosmetic changes do not qualify.
- *Food processing*, except the activities carried out at a retail establishment.

## Qualifying production property

"Qualifying production property" generally includes any tangible personal property, computer software or sound recordings.

"Qualified film" includes any motion picture film or videotape, other than certain sexually explicit productions, if 50 percent or more of the total compensation relating

to the production of such film, other than compensation in the form of residuals and participations, constitutes compensation for services performed in the United States by actors, production personnel, directors and producers.

### Limitations and special rules

The deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, as well as being limited to 3, 6 or 9 percent of the taxpayer's overall taxable income. Members of an affiliated group are treated as a single taxpayer, and the deduction is allocated among the members in proportion to each member's qualified production income.

Regarding the production activities of a pass-through entity, i.e., S Corporation, partnership, trust, etc., the wage limitation is administered at the entity level, and the deduction is determined at the shareholder, partner or similar level in proportion to ownership.

Additional rules permit the deduction for alternative minimum tax purposes.

All taxpayers will apply the following table to determine what percentage of their qualifying income is deducted from taxable income on or after January 1, 2005:

Year	Deduction
2005	3 %
2006	3 %
2007	6 %
2008	6 %
2009	6 %
2010 and beyond	9 %

### How help

The opportunities and effects of the American Jobs Creation Act of 2004 reach into many areas of how organizations do business and are taxed on those activities. We have highlighted two of the more prominent opportunities enacted. Now is the time to act and position your company or firm to maximize these benefits. Our tax advisors are fully versed in the new law and can assist you in analyzing the myriad of opportunities presented by the Act.

#### For additional information, contact:

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