

Business owners need to start planning for new manufacturing tax deduction

If you own a business, you've probably heard of the new tax deduction for manufacturers. It's part of the giant American Jobs Creation Act of 2004, one of the biggest business-focused tax laws to be passed by Congress in the last 20 years. This new tax law was signed into law by the President on October 22, 2004. When Congress repealed a special tax regime for America's exporters within this new law, it created a new deduction for manufacturers. The new deduction is broad and applies to many businesses that may not otherwise be thought of as traditional manufacturers.

The new deduction is one of the biggest changes to the Tax Code in years because it impacts so many businesses in the U.S. Congress also wasted no time in making the new deduction available. It starts next year, so it's critical that you start planning for how to take advantage of this new tax break.

Complexity problems

The new manufacturing deduction is very complex. One of the reasons it is so complicated is because Congress wanted it to apply to the maximum number of businesses. The regime it replaces, the FSC/ETI rules, is one of the most complex in the Tax Code, but it applies to only a small number of very large manufacturers. The new deduction, on the other hand, is available to all manufacturers. That's an incredibly diverse group of businesses.

Even the IRS has admitted that the new deduction is difficult to understand. In a recent letter to Congress, IRS Commissioner Mark Everson wrote that many businesses, especially small business, will be confused by the scope and limitations of the new deduction. Everson emphasized that the IRS will try to make the new rules and regulations as simple as possible. However, because the new deduction is so complex, that task may be "impossible," Everson wrote.

Lower tax bills

The deduction will reduce your tax bill to Uncle Sam. It starts at three percent of your taxable income attributable to "manufacturing" and grows to nine percent by 2010. The percentages are simple to understand and apply. Deciding what is manufacturing income is not.

Broadly speaking, manufacturing income equals your domestic production gross receipts minus the cost of goods sold. Various deductions, losses and expenses also have to be taken into account. Because the deduction comes into effect in 2005, Treasury and the IRS will have to write rules and regulations explaining what is manufacturing income very soon.

Who qualifies?

First, let's take a look at who does not qualify for the deduction. It may be easier to understand who is eligible for the deduction by eliminating who isn't.

Generally, service providers do not qualify for the deduction. For example, businesses selling food and beverages are generally not "manufacturers" under the new law. This would cover dining-in restaurants and take-out places. However, it's likely that many service providers will claim they are "manufacturers." For example, when a fast-food restaurant sells hamburger is it providing a service or is it combining inputs to manufacture a product?

Traditional manufacturers have an easier time. If you are making or fabricating a product, you generally qualify for the deduction. This includes businesses producing power, such as electric companies. Agricultural products are another gray area. Businesses handling, storing or processing agricultural products generally qualify for the new deduction.

Some businesses were able to lobby their lawmakers and get included in the bill even though they are not what most people think of as "manufacturers." Congress expressly made construction companies, engineering and architectural firms eligible for the new deduction.

Good news

One piece of very good news is that the new deduction is available to all forms of businesses. It doesn't matter if your business operates as a corporation, an S corporation, a partnership, a cooperative, or whatever. Congress also didn't limit the deduction to large businesses. However, the deduction cannot exceed more than 50 percent of the wages you pay to employees.

Everyone is waiting for new rules and regulations about the new deduction from the IRS. In the meantime, let's sit down and review what we already know about the new deduction and see if your business can qualify for this tax break. Give our office a call today.