



PIASCIK & ASSOCIATES
CERTIFIED PUBLIC ACCOUNTANTS

Main / 804-527-1815

Toll Free / 866-527-1815

Fax / 804-527-1816

Innsbrook Corporate Center

4470 Cox Road, Suite 250

Glen Allen, Virginia 23060

November, 2005

Mr. A. Smith
ABC Smith Company

Dear Mr. Smith:

New Tax Incentive for Domestic Producers and Repeal of Old Tax Incentive for Exporters

2005 marks the year that new tax law changes make yet another set of complicated tax laws take effect, which may have a large impact on the profitability of your export sales. The new tax law, which has now been referred to as the "Domestic Manufactures'/Producers' Deduction" (MPD) is part of the legislation included in the American Jobs Creation Act of 2004 that was passed during the fourth quarter of 2004. This new tax incentive regime was enacted to replace the Foreign Sales Corporation ("FSC") regime and the Extraterritorial Income ("ETI") regime both of which were ruled by the World Trade Organization ("WTO") to be illegal export subsidies. Since the WTO ruling, the U.S. has had a mandate to repeal the two regimes or face stiff sanctions such as high tariffs from foreign countries on U.S. goods.

The new tax incentive allows manufacturers to claim a deduction for a percentage of what is termed "qualified production activities income ("QPAI")" (beginning at 3% and increasing to 9%).¹ The deduction is not limited to manufactured products, however, since QPAI can include income a taxpayer derives from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (subject to certain exclusions). The deduction is limited to the lesser of taxable income or QPAI and further limited to half (50%) of the taxpayer's domestic wages for a taxable year (thus enhancing the value of domestic labor over foreign labor). This deduction to taxable income will be phased in at 3% for tax years beginning in 2005 and 2006, and 6% for tax years beginning 2007 through 2009, and then will ultimately reduce taxable income by 9% thereafter.

Below is a simplified example of how to compute the new tax deduction and the respective tax benefit.

¹ QPAI eligible for the deduction is equal to "domestic production gross receipts" decreased by the sum of the costs of goods sold that are directly allocable to such receipts and other deductions (e.g., S, G&A) directly and even indirectly related to such receipts.



Year	2005	2006	2007	2008	2009	2010
Gross Sales	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
Direct Materials and Overhead	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)
Direct Labor	(4,000,000)	(4,000,000)	(4,000,000)	(4,000,000)	(4,000,000)	(4,000,000)
Gross Margin	4,000,000	4,000,000	4,000,000	4,000,000	4,000,000	4,000,000
<S, G&A>	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)	(2,000,000)
Domestic Manufacturing/Production Activities Income	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
Applicable Deduction Percentage	3%	3%	6%	6%	6%	9%
Domestic Manufacturing Production Activities Deduction	(60,000)	(60,000)	(120,000)	(120,000)	(120,000)	(180,000)
Taxable Income	1,940,000	1,940,000	1,880,000	1,880,000	1,880,000	1,820,000
Tax Benefit (35% Tax Rate)	21,000	21,000	42,000	42,000	42,000	63,000

Impact of the New Legislation

Considerable tax savings can be obtained by maximizing this new tax deduction. Additionally, it is important to note that while this new regime is to be phased in over a period of time through 2009, the older ETI export tax incentive regime is still in effect and is scheduled to be phased out through the end of 2006. However, the concept of what constitutes "manufacturing" or "production" has yet to be defined thus it may present a number of planning opportunities such as:

- (1) How much value must be added to an item before it is considered manufactured?
- (2) Will resale exporters be entitled to the deduction if they do not manufacture or produce the product?
- (3) Who is entitled to the deduction when the primary producer uses a third-party contract manufacturer for portions of the production activity?
- (4) Will the states fully conform to the new federal law? If a state does not, it may make sense to relocate manufacturing operations in order to claim the deduction in a state that does conform.
- (5) What will be the appropriate allocation and apportionment method of manufacturing and/or production costs?
- (6) The financial statement reporting implication is unknown, since "special deductions" are generally not recognized until the year a deduction is taken into account.

Considerable tax savings can be obtained by maximizing this new tax deduction. Additionally, it is important to note that while this new regime is to be phased in over a period of time through 2009, the older ETI export tax incentive regime is still in effect and is scheduled to be phased out through the end of 2006. Companies currently utilizing the old ETI provisions may want to



accelerate sales for 2005 if the combined use of reduced ETI benefit and initial QPAI deductions is lower in 2006.

Therefore, it is extremely important for taxpayers, including U.S. exporters, to fully understand and determine which regime they intend to use for purposes of computing their tax deduction. It is also possible for taxpayers to choose to use BOTH regimes and compute two independent tax deductions for the same activity. Our Firm, which specializes in international taxation, which includes U.S. exporters, would certainly appreciate the opportunity to assist you on these complex matters.

Piascik & Associates, P.C., provides premier tax, business, and financial services to a broad range of clients throughout the United States, Canada and abroad. For more information, please visit www.piascik.com, or call Ryan Losi directly at (804) 228-4179.

Very truly yours,
PIASCIK & ASSOCIATES, P.C.

Ryan L. Losi, CPA, REALTOR
Business Development Manager