



## The Manufacturing Deduction Nearly Every Business Can Use

### Introduction

Manufacturing has been the back bone of the American economy for decades. Ford Motor, General Motors, and Chrysler are prime examples of manufacturers that built this economy and arguably this nation into the economic powerhouse it is today. Their survival largely depends on the cost of resources and labor, demand, taxes, and many other factors. Cost of resources, labor, demand, and most of the other factors are dictated by the invisible hand of economics and prevailing market conditions. Taxes of course are not; and as such, the federal government has decided to give them a break in light of recent

foreign competition, decreased demand, and generally rising costs. Closely held and even family businesses can also benefit from this new tax law.

### Intent

The Manufacturer's Deduction is no longer confined to United States Exporters! Instead it is based on manufacturing items in the United States. With the American Jobs Creation Act of 2004, Congress transformed a little known, little used credit (commonly referred to as FSC and ETI) into a credit that is applicable to anybody manufacturing nearly anything. The old credit was declared illegal by the World Trade

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## A CASE STUDY

### Royalty Payments

The Tax Court recently ruled that the shareholder of a corporation could not circumvent employment taxes by calling wages "royalty payments". The taxpayer was incorporated as a C Corporation employing two people, one of which was the

owner. The corporation entered into an agreement with the owner to pay wages, rent, and royalties. Over the years, the wife received nearly \$200,000 in royalty payments. The IRS then made an assessment for unpaid employment taxes. In Court, the taxpayer did not argue the merits of the case, but instead attacked

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Organization. As such, Congress repealed the credit slowly as not to disrupt manufacturers. The replacement is commonly known as the Manufacturers Deduction. Its scope is substantially wider than the old deduction. Not only does this deduction apply to big manufacturers such as Ford and GM, it applies to many companies not traditionally considered manufacturers.

### **Manufacturer Defined**

Manufacturers are now defined broadly. In fact the definition has been interpreted to be so broad; places which brew coffee could possibly be included as a manufacturer for this deduction. The legislative history also says farmers, miners, lumberjacks, and anyone else who grows, manufactures, extracts products in the United States qualifies for the deduction. It is safe to say that if you are producing or assembling anything of value, you may qualify for this deduction. More examples of manufacturers (based off of interpretations from the IRS) includes electricity producers, miners, oil pumps, lumber mills, newspapers; even engineering, construction companies and architectural services and the like are eligible for the deduction.

### **The Deduction**

The deduction is equal to a phased in percentage of the lesser of the following amounts: 1) Taxable Income or 2) Qualified Production Activities Income. Taxable income is self explanatory, no adjustment must be made. Qualified Production Activities Income (QPAI) has been defined as being a manufacturer's domestic gross receipts reduced by A) cost of goods sold allocable to QPAI receipts, B) other



deductions, and expenses allocable to QPAI receipts, and C) Indirect costs associated with QPAI.

Initially, the deduction starts at 3% for 2005 and 2006. For 2007, 2008, and 2009, the deduction percentage is doubled to 6%. In 2010 AND THEREAFTER, the deduction percentage is 9%.

### **Conclusion**

You will notice that this deduction does not sunset as many other recently enacted provisions of the tax law have done. This law provides for uninterrupted, low taxes in future years. If you think you have an operation that may qualify or would like to save on taxes, contact the professionals at The Center for a determination and strategy.

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jurisdiction. That point was quickly disposed of and the court determined the taxpayer was deficient and owed the taxes, penalties and interest.

**Editor's Comment: Despite what a taxpayer chooses to call remuneration for employment, it is still a wage subject to employment taxes including Medicare and Social Security. There are many instances where the substance and not the form will dictate how a transaction is taxed. Calling wages anything other than wages, will not change its tax character. With closely held businesses, there are plenty of ways to reduce taxes legally. Everyone is entitled to follow an aggressive strategy.**



### **Why Use an M&A Professional - Part I**

Thousands of small- to medium-sized businesses sell privately every year, so why use an M&A Professional? There are several reasons, but in my experience most of my clients say they chose me to help them get the best possible result from the years they invested in building their business.

An experienced M&A professional can more than earn his fee by improving the price & terms an owner will realize from selling his business. In a recent case, a business owner asked me to take over the sale of his business after he had attempted to sell it himself for almost a year. He reported that even after lowering his asking price to less than \$1M, his trade journal ads hadn't produced a single offer.

After working with the owner to recast his financial history and repackage his marketing materials, and after exposing his business through blind ads to our network of buyers, within 8 months we successfully closed with a strategic buyer for 50% more than the seller's last asking price. The deal also included several perks that made the deal even sweeter for this seller.

If you know of a business owner who's thinking of selling and who might benefit from a free consultation with us, have them contact me or any of the M&A professionals at [www.bradwaygroup.com](http://www.bradwaygroup.com)

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## Frequently asked questions:



**Q: How long do the low capital gains rates remain in effect?**

A: The 5% / 15% capital gains rates remain in effect until the end of 2007. In 2008, the 5% rate drops to 0% for bottom bracket tax payers. In 2009, the capital gains tax rate reverts back to the old 10% / 20% rates. However, our government is currently debating whether to extend this provision of the tax law indefinitely.

**Q: How does the new year affect estate tax planning?**

A: Good news! The gift exclusion rises from \$11,000 to \$12,000. The estate tax exemption rises from \$1,500,000 to \$2,000,000. These raised amounts are a breath of fresh air for those facing potential estate taxes.

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