

A NEW TAX BREAK FOR BUSINESSES TAKES EFFECT IN 2005

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Late last year, Congress enacted a new deduction for many businesses. Although the provision is complex, the concept is simple. If a business (a corporation, partnership or sole proprietorship) meets the requirements, it gets a deduction in 2005 equal to 3% of its net production income from U.S. sources. In future years, this deduction increases to 9% of net U.S. production income. Since many small businesses only have income from sales within the US, the net result is a 3% deduction from taxable income.

Production income is broadly defined to include the rental or sale of personal property, computer software or sound recordings manufactured, produced, grown, or mined within the U.S. Agricultural activities that qualify include not only raising crops and livestock, but soil cultivation, and fishing. Also included is revenue from construction and substantial renovation projects in the U.S., as well as U.S. based engineering or architectural services. However, prepared food and beverage sales at a restaurant don't qualify and sales between related parties are also excluded.

Since the deduction is computed on net income from U.S. production activities, the complexity of determining the proper deduction depends on whether there are both U.S. income sources and foreign sources. For businesses with only U.S. source income, the net income will simply include all of the business' income (excluding interest income and other investment income) as well as all of the deductions attributable to the production income.

However, if a business has both U.S. source and foreign source income, the calculations can become very complex. First, the U.S. sourced income must be reduced by the cost of the products sold or the direct costs of producing the property. Next, indirect costs allocable to the U.S. sourced income must be deducted. Finally, a pro-rata share of overhead, not directly allocable to any specific type of income, must be deducted.

Fortunately, the IRS has provided some simplified methods for allocating the deductions for small businesses. These simplified methods base the deductions on the ratio of U.S. source income to total income.

Even after all of this, there is still one other limitation that applies. The deduction is further limited to the lesser of 3% of the net U.S. sourced production income or 50% of the W-2 wages reported by the business. This poses a serious problem for many small businesses with few or no employees. For example, if a small business is entitled to a \$5,000 deduction based on 3% of net production income, but has no employees, the deduction is zero. This may be a particular problem for many small construction companies that use subcontractors for all of their work. Even though the contractor may generate substantial income from the construction projects, it will get no deduction because it paid no W-2 wages.

Don't wait until year-end to figure out what tax break your business may get from this new deduction. Planning is important if your business is to maximize its deduction. Planning actions that can help boost the deduction include hiring one or more employees, maintaining better records of costs and expenses and considering how to maximize the allocations to U.S. source income. Waiting until after December 31, 2005 to look at this new deduction may mean you pay Uncle Sam more than you should.

The new law is very complex, with twists and traps that will catch the unwary. Consulting your CPA is a good start to taking full advantage of a tax break Congress has provided.