



BDO Seidman, LLP
Accountants and Consultants

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Issue:

Production Activities Deduction Replaces Extraterritorial Income Exclusion

International Tax Alert

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Date\Timing:

Since September 30, 2000 the Extraterritorial Income Exclusion (EIE) has provided significant benefits to U.S. exporters. However, in 2002 the World Trade Organization ruled that the EIE was a prohibited export subsidy and they imposed punitive tariffs beginning on March 1, 2004. The recently passed American Jobs Creation Act of 2004 repealed the EIE, replacing it with a new tax deduction for taxpayers with qualified production activities income ("QPAI").

Affecting:

U.S. taxpayers that generate income from exporting activities or who are involved in the domestic production of certain goods.

Details:

- The exclusion for extraterritorial income is repealed for transactions after 2004.
- Transitional Relief- The transitional relief allows taxpayers to retain a portion of their otherwise-applicable EIE benefits: 100% for transactions during 2004; 80% for transactions during 2005; 60% for transactions during 2006.
- The exclusion for extraterritorial income remains in effect for certain transactions under a binding contract between the taxpayer and an unrelated person that was in effect on September 17, 2003, and at all times thereafter. A binding contract would include a purchase option, renewal option, or replacement option that is included in such contract and that is enforceable against the seller or lessor.

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Details:...(continued)

- The Act provides a new tax deduction equal to the lesser of:
 - i) a percentage of the QPAI of the taxpayer for the tax year,
 - or ii) the taxpayer's taxable income for the tax year.
- The eligible percentage of QPAI would be: 3% in 2005 through 2006; 6% in 2007 through 2009 and 9% in tax years beginning in 2010.
- QPAI would generally be equal to the excess (if any) of: The taxpayer's domestic production gross receipts for such tax year, over the sum of:
 1. The cost of goods sold that are allocable to such receipts,
 2. Other deductions, expenses, or losses directly allocable to such receipts, and
 3. A ratable share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.
- Domestic production gross receipts generally would include the gross receipts of the taxpayer which are derived from:

Any lease, rental, license, sale, exchange, or other disposition of:

1. Qualifying production property, which was manufactured, produced, grown, or extracted in whole or in significant part by the taxpayer within the United States,
2. Any qualified film produced by the taxpayer,
3. Electricity, natural gas, or potable water produced by the taxpayer in the United States,
4. Construction performed in the United States, or
5. Engineering or architectural services performed in the United States for construction projects in the United States.

Recommended Action:

- Review current manufacturing and production activities to determine whether the new law will provide a tax benefit.
- Assess alternative export benefits for taxpayers taking advantage of the EIE.

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