June 23, 2003

M&P EXCLUSION

Technical Explanation

Overview

The bill provides a new exclusion from gross income of income earned from the manufacturing and processing in the United States of goods for sale, lease, or license (the "M&P exclusion") and repeals the existing extraterritorial income exclusion. The amount of the M&P exclusion is 15 percent of qualified M&P income. The exclusion is allowed under both the regular tax and alternative minimum tax, but it does not affect payroll taxes. It is effective for taxable years beginning after December 31, 2003.

Determination

Computation: The M&P exclusion equals 15 percent of qualified M&P income. Qualified M&P income equals the active business income of a taxpayer multiplied by the M&P percentage of the taxpayer.

Active business income: In general, active business income is taxable income (determined without regard to the M&P exclusion, dividends received deduction, and net operating loss deduction), excluding investment income (such as dividends, interest, rents, royalties, and any gain or loss on dispositions). However, income from the lease or license of property manufactured or processed by the taxpayer in the United States is includible in active business income.

Active business income does not include any income from a business outside the United States. For this purpose, income whose source is determined under section 863(b) is not considered income from a business outside the United States. The "United States" includes the Commonwealth of Puerto Rico and the U.S. Virgin Islands.

All expenses must be apportioned between active business income and all other income. The taxpayer's active business income is determined on an aggregated basis—that is, the aggregate of all income in excess of the aggregate of all losses. If this computation results in a negative number for a taxable year then active business income is deemed to be zero for that year.

M&P percentage: In concept, the M&P percentage is the fraction of active business income that is attributable to manufacturing or processing.

The *denominator* of the M&P percentage is the sum of total labor cost and total capital cost (including labor and capital costs capitalized into cost of goods sold) determined, for administrative convenience, without regard to whether the labor and capital are employed in activities that produce active business income. Total labor cost equals the salaries and wages paid to employees of the taxpayer; it does not include other forms of remuneration, such as contributions to retirement plans and the employer's share of payroll taxes. Total capital cost equals (a) 10 percent of the original cost of the taxpayer's depreciable property used during the taxable year and still on hand at year-end plus (b) the annual rental cost of rented property.

The *numerator* of the M&P percentage is the sum of M&P labor cost and M&P capital cost. M&P labor cost is 1.3333 times the salaries and wages paid to employees who predominantly are engaged directly in the taxpayer's M&P activities. M&P capital cost is 1.1765 times the portion of total capital cost of assets which predominantly are used directly in the taxpayer's M&P activities. (The purpose of the multiplicative factors—i.e., 1.3333 and 1.1765—is to augment direct costs for other costs that may be administratively difficult to allocate to M&P but are necessary for M&P.)

In general, product research, engineering design of products, receiving and storing raw materials, production, assembly, handling, inspection of goods produced, line supervision, quality control and production control, packaging of goods produced, maintenance and repair of production facilities, and pollution control are examples of activities in which labor is directly engaged and capital is directly used in the taxpayer's M&P activities. In general, storing and shipping finished goods, purchasing, selling, reselling, administration, clerical work, personnel affairs, accounting and similar data processing, and providing services to customers are examples of activities that are not "direct."

Pass-Through Businesses.—The M&P exclusion is available to pass-through and other noncorporate businesses. It is calculated at the entity level and passed through to owners.

Manufacturing and Processing

To be qualified M&P income, the taxpayer's income must be from manufacturing or processing. Manufacturing or processing is the mechanical, physical, or chemical transformation of materials, substances, or components into new products. The assembling of component parts of manufactured products is considered manufacturing. It includes farming, fishing, logging, and mining. In addition, it includes the production of films, tapes, records, and computer software (including software produced by the taxpayer and integrated in products manufactured by the taxpayer). In the case of a taxpayer that manufactures a product and installs it for first use by a customer, the installing is considered part of manufacturing and the related costs are direct M&P costs.

Qualified M&P income does not include income from construction; providing electricity, water, and other utilities for sale; extracting oil or natural gas; operating an oil or gas well; and the leasing or licensing of any property not manufactured or processed by the taxpayer.

Effective Date

The M&P exclusion is effective for taxable years beginning after December 31, 2003. Repeal of the extraterritorial income exclusion is effective for taxable years beginning after December 31, 2005.

As a transitional measure, the M&P exclusion is reduced by two-thirds for the first taxable year beginning after December 31, 2003 and by one-third for the first taxable year beginning after December 31, 2004. The exclusion of extraterritorial income is reduced by one-third for the first taxable year beginning after December 31, 2003 and by two-thirds for the first taxable year beginning after December 31, 2004.

End