

## RIA/Thomson Special Study

### 10/11/04 -- Advance look at key provisions in the American Jobs Creation Act of 2004

**A CONFERENCE** agreement on H.R. 4520, the "American Jobs Creation Act of 2004" was reached on Oct. 6, 2004, after months of debate on how to proceed with this legislation to repeal the exclusion for extraterritorial income, which the World Trade Organization had ruled amounted to an illegal export subsidy. The Act goes well beyond addressing the illegal subsidy and creates billions of dollars of new tax breaks for a broad spectrum of taxpayers. However, it is fully offset by a number of revenue provisions.

The House passed the measure on Oct. 7 by a vote of 280-141 and the Senate passed it on Oct. 11 by a vote of 69-17. The Administration had expressed some concerns about the size of the measure but the President is expected to sign it.

This *Special Study* provides brief explanations of key provisions of the Act, which is over 600 pages long.

#### **Repeal of Exclusion for Extraterritorial Income (ETI)**

- For transactions after 2004, the Act repeals the ETI system of tax benefits subject to transition relief for 2005 and 2006 and grandfather rules for contracts entered into before Sept. 18, 2003. (Act Sec. 101)
- For tax years beginning after 2004, the Act provides a 9% deduction (equal to a 3% rate cut) on all manufacturing (and certain other domestic production) activity undertaken in the U.S., whether it is exported or not. The deduction is available to C corporations, S corporations, partnerships, sole proprietorships, cooperatives, and estates and trusts, and, subject to an adjustment, is allowed for AMT purposes. The deduction is phased in over five years: 3% in 2005-2006, 6% for 2007-2009, 9% after 2009. (Act Sec. 102)

#### **Business Tax Incentives**

- The Act extends for an additional two years the increased amounts that a taxpayer may expense under Code Sec. 179 (\$100,000 indexed for inflation) and other expensing enhancements so that they continue through 2007 tax years. (Act Sec. 201)
- The Act treats qualified leasehold improvements and restaurant property placed in service after the enactment date and before 2006 as 15-year recovery property depreciated on a straight-line basis.
- The Act directs IRS to issue new regs for the designation of targeted areas for the new markets tax credit. (Act Sec. 221)

- For tax years beginning after 2004, the Act allows family members to elect to be treated as one shareholder for purposes of determining the number of shareholders of an S corporation (Act Sec. 231) and increases the maximum number of S shareholders from 75 to 100. (Act Sec. 232)
- The Act allows an IRA to hold S corporation bank stock that the IRA held on the enactment date with the IRA owner treated as the shareholder and allows the stock to be sold to the beneficiary for fair market value upon the corporation making an S election. (Act Sec. 233)
- For tax years beginning after 2004, the Act disregards unexercised powers of appointment in determining the potential current beneficiaries of a special type of trust for holding S stock known as an electing small business trust (ESBT), and increases the period during which a trust can dispose of stock after an ineligible shareholder becomes a potential current beneficiary from 60 days to one year. (Act Sec. 234)
- For tax years beginning after 2004, the Act allows suspended losses to be transferred with transfers of S stock to a spouse or former spouse incident to divorce. (Act Sec. 235)
- For tax years beginning after 2004, the Act permits a beneficiary of a qualified Subchapter S trust (QSST) to deduct suspended losses under the at-risk and passive loss rules when the trust disposes of S stock. (Act Sec. 236)
- For elections and terminations after 2004, the Act provides relief from inadvertently invalid qualified Subchapter S subsidiary (QSub) elections and terminations (Act Sec. 238) and allows QSubs to file information returns. (Act Sec. 239)
- For distributions after '97, the Act permits an S corporation to use distributions on stock held by its ESOP to repay loans, provided that stock of at least equal value is allocated to participant accounts. (Act Sec. 240)
- For Small Business Investment Companies (SBICs) formed after the enactment date, the Act excludes from the debt-financed property rules debt incurred by an SBIC that is evidenced by a debenture issued by it under section 303(a) of the Small Business Investment Act of 1958 and that is held or guaranteed by the Small Business Administration. (Act Sec. 247)
- For tax years beginning after the enactment date, the Act generally allows corporations to elect a "tonnage tax" on their taxable income from certain shipping activities in lieu of the U.S. corporate income tax. (Act Sec. 248)
- For options exercised after the enactment date, the Act excludes certain stock options and stock purchase plans from employee wages for payroll tax and income tax withholding purposes. (Act Sec. 251)

### **Agricultural Tax Relief and Incentives**

- The Act repeals the reduced rates of excise tax for most alcohol-blended fuels and instead creates two new excise tax credits: the alcohol fuel mixture credit (Act Sec. 301) and the biodiesel mixture credit. (Act Sec. 302).

- For any tax year for which the due date (without regard for extensions) for the return is after 2002, if a rancher is forced to sell livestock as a result of drought he must pay tax on any gain unless he reinvests in livestock or, as added by the Act, in other ranch equipment or property, within 4 years (increased from 2-years under pre-Act law). (Act Sec. 311)
- Effective after the enactment date, the Act provides that, to the extent provided in organizational documents of the cooperative, dividends on capital stock won't reduce patronage income or prevent the cooperative from being treated as operating on a cooperative basis. (Act Sec. 312)
- For tax years after the enactment date, the Act provides that the small producer tax credit flows through to cooperative members. (Act Sec. 313)
- For tax years beginning after 2003, the Act extends the option of income averaging, which under pre-Act law is available to farmers, to individuals engaged in the trade or business of fishing and it coordinates income averaging with the AMT so that use of averaging won't increase AMT. (Act Sec. 314)
- The Act provides capital gains treatment on the outright sale of timber by a landowner after 2004. (Act Sec. 315)
- The Act extends the 50% bonus depreciation for small aircraft by one year so that it applies through 2005. (Act Sec. 336) Tax Reform and Simplification for U.S. Businesses
- The Act includes several provisions to reduce double taxation of U.S.-based companies, such as reducing the foreign tax credit (FTC) baskets from nine to two for tax years beginning after 2006 (Act Sec. 404) and allowing FTCs to be carried forward for 10 years instead of five for excess foreign tax credits that may be carried to any tax years ending after the enactment date. (Act Sec. 417).
- For tax years beginning after 2004, the Act repeals the 90% limitation on the use of FTCs against the AMT. (Act Sec. 421)
- The Act encourages companies to reinvest foreign earnings in the U.S. by temporarily making certain dividends received by a U.S. corporation from controlled foreign corporations eligible for an 85% dividends-received deduction. At the taxpayer's election, this deduction is available for dividends received either during (i) the taxpayer's first tax year beginning on or after the enactment date, or (ii) the taxpayer's last tax year beginning before such date. (Act Sec. 422)

### **Deduction of State and Local General Sales Taxes**

- For 2004 and 2005, the Act allows taxpayers to deduct state and local sales taxes instead of state income taxes. Taxpayers may deduct their actual sales taxes or use IRS-published tables. (Act Sec. 501)

### **Miscellaneous Provisions**

- For property acquired after 2004 and before 2010, the Act excludes from unrelated taxable income of tax-exempt investors gain or loss from the sale or exchange of a qualifying brownfield property and excepts such property from the debt-financed property rules. (Act Sec. 702)
- For a judgment or settlement occurring after the enactment date, the Act allows an above-the-line deduction for attorney's fees and court costs incurred in connection with an unlawful discrimination claim. (Act Sec. 703)
- Generally for electricity sold and produced after the enactment date, the Act expands the credit for electricity produced from renewable resources to include open-loop biomass, geothermal and solar energy, small irrigation power, landfill gas, trash combustion and refined coal production facilities. (Act Sec. 710)
- For tax years ending after the enactment date, the Act allows the tax credits for alcohol fuels and for the production of electricity to be applied against AMT. (Act Sec. 711)

### **Offsetting Revenue Provisions**

The Act offsets the costs of its new tax breaks, by, among other items:

- Reducing tax avoidance through corporate inversions and individual expatriation. (Act Secs. 801 – 806)
- Shutting down abusive tax shelters by: creating a steep new penalty for failing to disclose reportable transactions, strengthening the accuracy-related penalty, weakening confidentiality privileges, lengthening the limitations period for failing to disclose listed transactions, and other items. (Act Secs. 811 – 820)
- Closing numerous loopholes. (various Act Secs.)
- Combating fuel tax evasion. (Act Sec. 851 – 871)
- Tightening (a) the reporting rules for noncash charitable contributions (Act Sec. 883) and (b) the rules for deducting contributions of (i) patents and similar property made after June 3, 2004 (Act Sec. 882), and (ii) motor vehicles, boats and airplanes made after 2004 (Act Sec. 884)
- Making it more difficult to defer tax on nonqualified deferred compensation for amounts deferred in tax years beginning after 2004. (Act Sec. 885)
- Extending IRS user fees. (Act Sec. 891)
- Limiting the amount of the cost of an SUV that may be expensed in a single year to \$25,000 for property placed in service after the enactment date. (Act Sec. 910)

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