PKF PERSPECTIVES

AMERICAN JOBS CREATION ACT OF 2004

Overview for Individuals and Owners of Small or Closely-Held Businesses

This newsletter provides a broad overview of a significant new tax law, the ***American Jobs Creation Act of 2004*** *(the "Tax Act")*, that the President signed on October 22, 2004. Although the Tax Act has many provisions which affect large businesses, particularly multinationals, the wide-ranging law has several provisions affecting individuals and small or closely-held businesses.

On the positive side, the new law:

- creates a new deduction—with potentially widespread applicability—for businesses having income "attributable to domestic production activities";
- extends previously-enacted increases in the small business "expensing" allowance;
- liberalizes the rules governing S corporations;
- permits itemizers to deduct their state and local sales taxes in lieu of state and local income taxes (effective for tax years 2004 and 2005).

On the revenue-raising side, the new law:

- limits the "expensing" allowance for sport utility vehicles (SUVs) placed in service after the new law's enactment date to $25,000;
- starting January 1, 2005, imposes tighter rules on taxpayers who want to claim a deduction of more than $500 for motor vehicles, boats, or airplanes donated to charity;
- imposes tighter rules for documenting charitable contributions of property made after June 3, 2004;
- dramatically toughens the rules for "nonqualified" deferred compensation plans, which are used by business owners and other executives as a supplement to, or in lieu of, the "qualified" retirement plans generally available to employees of a business.

Here is a summary of the new law, followed by a little more detail about the above-mentioned changes.

Overview of the New Law

The impetus for the new law was a 2002 World Trade Organization ruling that the U.S. tax code's "extraterritorial income exclusion" was a prohibited export subsidy. The law addresses that issue by repealing the exclusion—with generous transitional rules—and creating the new production activity deduction mentioned above.

In addition, however, lawmakers used the new law as a vehicle for a variety of legislative initiatives that had been pending for, in certain cases, several years. Some of these could be called "special interest legislation," but many enjoy broad support and will have a favorable impact.

Incentives and Other Taxpayer-Favorable Provisions

The law contains a package of pro-taxpayer changes in U.S. international tax rules. Among other things, the new law:

- simplifies the foreign tax credit rules;
- provides a 10-year carryforward and one-year carryback of the foreign tax credit;
- repeals the 90% limitation on using foreign tax credits against the alternative minimum tax (AMT);
- provides a temporary incentive in the form of an 85% dividends received deduction for corporations to "repatriate" their foreign earnings within a limited timeframe;
- repeals the foreign personal holding company and foreign investment company rules.

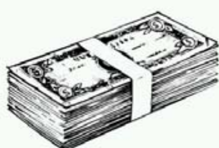
Other incentives are directed toward agriculture and small manufacturing. The list of about two dozen incentives includes:

- income and excise tax credits for biodiesel used in certain fuel mixtures;
- a provision allowing fishermen—in addition to farmers—to use income averaging, and providing that income averaging will not increase alternative minimum tax (AMT) liability (effective retroactively to January 1, 2004);
- a deduction for the first $10,000 of qualified reforestation expenditures (effective for expenditures paid or incurred after the date of enactment).

Finally, more than a dozen provisions are lumped into the "Miscellaneous" category. These include a provision extending and expanding the credit for electricity produced from renewable energy resources, as well as a provision that allows that credit and the alcohol fuels credit to be used against alternative minimum tax (AMT) liability.

Revenue Raising Provisions

To offset the projected revenue losses from the pro-taxpayer changes, the new law adds an extensive collection of revenue-raising measures, broken down into four broad categories: ***expatriation, tax shelters, fuel tax evasion, and "other revenue provisions.***"



The new law adds expatriation rules for business entities and tightens the rules applicable to individuals. Broadly speaking, the effect of the rules is to limit or eliminate the intended tax benefits of certain actions that may be taken by individuals (e.g., renouncing U.S. citizenship) or corporations (e.g., becoming subsidiaries of a foreign parent) for the purpose of removing themselves from worldwide U.S. tax jurisdiction.

The "tax shelters" category comprises 30 provisions. Several are procedural in nature, e.g., a new penalty for failing to disclose "reportable transactions," changes in the substantial underpayment penalty, and changes in certain reporting requirements.

Other "tax shelter" provisions change substantive tax rules. For example, one new rule prevents a taxpayer from excluding gain on the sale of a principal residence acquired in a tax-deferred like-kind exchange within the preceding five-year period. The most significant tax shelter provision seeks to curtail the tax benefits of certain leasing transactions with "tax indifferent parties" such as tax-exempt organizations and government entities, including foreign governments.

Provisions listed in the "fuel tax evasion" category modify a variety of excise tax rules.

Provisions affecting a variety of taxpayers, domestic and international, are scattered among the 30 miscellaneous measures in the "other revenue provisions" category.

One provision authorizes the IRS to hire private debt collection firms. Another requires a partnership to recognize (and pass through to its partners) cancellation of indebtedness income when it transfers a partnership interest to a creditor in satisfaction of a debt, whether recourse or nonrecourse. Still another seeks to prevent businesses from deducting the full costs of providing an aircraft to certain employees—in general, top-level executives, directors, and 10% owners—for personal purposes if those costs exceed the amount the employees must report as compensation income.

Provisions Affecting Individuals and Small or Closely-Held Businesses

Dozens of provisions affect individuals and small or closely-held businesses. Although day-to-day experience in working with the new law will undoubtedly reveal some implications that are not apparent at this point, we believe the provisions mentioned at the beginning of this newsletter are the most significant for the great majority of our clients. The remainder of this newsletter gives you a few more details about these provisions.

Deduction from Qualified Production Activities Income

As noted above, the deduction replaces the "extraterritorial income exclusion," which the new law repealed in response to the World Trade Organization ruling that the exclusion was a prohibited export subsidy. Although created because of an international trade dispute, **the new deduction is broadly applicable.**

When fully phased in, the deduction could be as much as 9% of "qualified production activities income," which, in essence, is the net income attributable to "domestic production gross receipts." The latter term encompasses much more than income from U.S.-based manufacturing activities. In

addition to traditional manufacturers, any business might qualify if it: (1) produces, grows, or extracts, (2) "in whole or in significant part within the United States," (3) any tangible personal property, computer software, or sound recordings; and (4) derives income from any "lease, rental, license, sale, exchange, or other disposition of" such property.

Other qualifying activities include:

- performing construction in the United States;
- performing engineering or architectural services in the United States for construction projects in the United States;
- producing electricity, natural gas, or potable water in the United States;
- producing films for which at least 50% of the total compensation was paid for services in the United States.

Taxpayers eligible for the deduction include individuals and passthrough entities such as S corporations, partnerships, and limited liability companies (LLCs), as well as C corporations.

More than 10% of small businesses will be affected by this provision, according to official estimates, and the Conference Committee report anticipates the need for "extensive additional regulatory guidance." With the new rule set to go into effect in taxable years beginning after December 31, 2004, such guidance presumably will be high on the government's priority list.

Nonqualifed Deferred Compensation Rules Toughened

The new law significantly changes the law of nonqualified deferred compensation and imposes potentially large tax penalties for noncompliance. Unless a nonqualified deferred compensation (NQDC) plan meets the requirements of a new Tax Code section, amounts deferred under the plan are includible in income back to the time of deferral or, if later, when no longer subject to a substantial risk of forfeiture, and are subject to interest at the underpayment rate plus 1% and a 20% additional tax.

The new law imposes requirements on NQDC plans with regard to participant elections, distributions, acceleration and funding that likely will necessitate amendments to most NQDC plans. A participant must make an election to defer compensation by the end of the taxable year preceding the year in which the employee will perform services for the company. Employees who are newly eligible must elect to defer within 30 days of becoming eligible. For performance-based compensation for services provided over a period of at least 12 months, the election must be made no later than six months before the end of the service period. The plan or the election must include the timing and form of a distribution.

Except as provided by regulations yet to be issued, distributions are permitted only upon the following triggers:

(1) separation from service;

(2) death of the participant;

(3) a specified time or pursuant to a fixed schedule (but not upon a specified event);

(4) change in control of the corporation;

(5) an unforeseeable emergency; or

(6) disability of the participant.

Also, except as provided by regulations, a plan may not accelerate a distribution. This provision negates such commonly used approaches as "haircuts," which permit a participant to take a distribution at any time, but the participant must forfeit a portion of his or her account balance over the amount of the distribution.

The new law provisions apply to amounts deferred after December 31, 2004. Earnings on amounts deferred prior to that date generally are not subject to the new requirements. However, if a plan is "materially modified" after October 3, 2004, amounts deferred to a plan generally will be subject to the new law. The new law directs the Treasury to issue guidance within 60 days of the date of enactment that would provide for a limited period of time during which elections as to deferrals made after December 31, 2004, could be cancelled and plans could be amended to conform to the new requirements.

Small Business "Expensing" Increases Extended

Previous legislation increased the annual allowance for taxable years beginning after 2002 and before 2006 to $100,000 (from $25,000) and the "phaseout" threshold to $400,000 (from $200,000), with annual inflation adjustments, and added off-the-shelf software as eligible property. For taxable years beginning after 2005, the dollar amount was scheduled to revert back to $25,000. The new law extends the increased annual allowance through taxable years beginning before 2008.

S Corporation Rules Liberalized

Several new rules make it easier to qualify as an S corporation or to retain that status. Among other things, the new law:

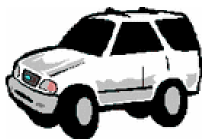
- treats certain family members as one shareholder for purposes of the limit on the number of eligible shareholders;
- increases the number of eligible shareholders to 100;
- provides relief from inadvertently invalid qualified subchapter S subsidiary ("QSST") elections.

Itemized Deduction for State and Local Sales Taxes

Individuals who itemize their deductions can now elect to deduct state and local sales taxes instead of state and local income taxes. Although the principal beneficiaries are residents of states that do not have an income tax, the new deduction provides an alternative for taxpayers living in states that impose both income and sales taxes. The amount of the deduction can be based on actual taxes paid or by using IRS-prepared tables.

This provision is retroactive to January 1, 2004. Therefore, the deduction will be available for individual returns due next April, and the IRS may have to scramble to incorporate this change. Taxpayers and return preparers should be alert for last-minute changes or corrections as the 2004 filing season approaches.

SUV Expensing Allowance Limited to $25,000



Previously, SUVs weighing more than 6,000 pounds were not subject to the limitations imposed on so-called "luxury" automobiles because their weight put them outside the limitation-triggering definition of "passenger" automobiles. The new law creates a separate category for such SUVs (including those rated at a gross vehicle weight of not more than 14,000 pounds) and imposes a $25,000 limit on the deduction. This limit will be effective for property placed in service on the date the President signed the legislation.

Charitable Deduction Rules Tightened

Obtaining a deduction for the charitable contribution of your car, or a boat or airplane, will be more difficult after December 31, 2004. After that date, you may no longer use the "Blue Book" value because your deduction is limited to the amount for which the charity later sells the vehicle. In addition to this limitation on the amount of your deduction, the charity must prepare, and you must attach to your return, a statement identifying the vehicle and stating the amount for which it was sold. Failure to attach the statement will result in disallowance of your deduction.

The legislation also includes new limitations on charitable donations of intellectual property, i.e., patents, copyrights and similar property, made after June 3, 2004. Rather than deducting the value of the intellectual property in the year of the contribution, you are now allowed to deduct only its cost, reduced by any amortization or depreciation deductions that you have taken. Then, over the next 10 years, you will be allowed to deduct a portion of any net income that the charity receives from its exploitation of the property, but only after offsetting the amount of the initial deduction.

Finally, the new law strengthens the requirements for substantiating contributions of property (excluding contributions of cash or publicly traded stock) made after June 3, 2004. The new law codifies existing IRS rules that require that: (1) certain information be provided on the return if the deduction exceeds $500; and (2) the taxpayer obtain a qualified appraisal for property with a value exceeding $5,000. There is also a new requirement that the appraisal be attached to the tax return when the deduction exceeds $500,000.

Items in this publication should not be considered official statements of position, nor advice for individuals or organizations without consulting a tax advisor. For more information, please contact Howard Pell or Leo Parmegiani at:

PKF

Certified Public Accountants
A Professional Corporation

29 Broadway • New York, NY 10006
Telephone: (212) 867-8000 • Telefax: (212) 687-4346
www.pkfnewyork.com
E-mail: info@pkfny.com

Issue No. 18 - November 2004