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BEAN KINNEY & KORMAN PC
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Business Law Newsletter

Ronald A. Feuerstein, a tax practitioner with 30 years of experience in the D.C. area, has joined Bean, Kinney & Korman.

Mr. Feuerstein's practice, covers a wide spectrum of tax law issues, including tax planning; structuring for corporate and partnership transactions; mergers and acquisitions; tax controversy work before IRS and state tax agencies; tax-exempt organizations; sophisticated estate planning for high net worth individuals and family wealth transfers; and employee benefits, including ERISA and executive compensation.

In this edition of the newsletter, Mr. Feuerstein summarizes certain selected provisions of the American Jobs Creation Act of 2004 which may affect your businesses, investments and individual tax situations.

Summary of Certain Provisions of the American Jobs Creation Act of 2004

H.R. 4520, the "American Jobs Creation Act of 2004" ("AJCA") began as a response to the World Trade Organization's ruling that the exclusion for extraterritorial income was an illegal expert subsidy. However AJCA, which is over 600 pages long, goes well beyond the repeal of the exclusion. It creates billions of dollars of new tax breaks for a broad spectrum of taxpayers. It is, however, fully offset by a number of revenue provisions.

AJCA was signed by the President on October, 22, 2004, which is the effective date of a number of provisions, many of which are noted below.

Repeal of Exclusion for Extraterritorial Income (ETI)

- For transactions after 2004, AJCA repeals the ETI system, subject to transition relief for 2005 and 2006 and grandfather rules for contracts entered into before September 18, 2003.
- For tax years beginning after 2004, AJCA 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 is allowed for purposes of the alternative minimum tax ("AMT") as well. The deduction is phased in over five years: 3% in 2005-2006, 6% for 2007-2009, 9% after 2009.

Business Tax Incentives; S Corporation Reforms

- AJCA extends for an additional two years (to 2007) the increased amounts that a taxpayer may expense under Code Sec. 179 ($100,000 indexed for inflation).

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"Getting It Done"

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- AJCA treats qualified leasehold improvements and restaurant property placed in service after the enactment date and before 2006 as 15 year recovery property depreciated using the straight-line method.

- IRS will issue rules designating targeted areas for the new markets tax credit.

- For tax years beginning after 2004, AJCA allows family members to elect to be treated as one shareholder for determining the number of shareholders of an S corporation and increases the maximum number of S shareholders from 75 to 100.

- For tax years beginning after 2004, AJCA disregards unexercised powers of appointment in determining the potential current beneficiaries of special trusts holding S stock (electing small business trust (ESBT)), and increases the period during which such a trust can dispose of stock after an ineligible shareholder becomes a potential current beneficiary, from 60 days to one year.

- For tax years beginning after 2004, AJCA allows suspended losses to be transferred with transfers of S stock to a spouse or former spouse incident to divorce.

- For transfers made after 2004, AJCA 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.

- For elections and terminations after 2004, AJCA provides relief from inadvertently invalid qualified Subchapter S subsidiary (Qsub) elections and terminations.

- For distributions after '97, AJCA 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.

- For options exercised after the enactment date, AJCA excludes certain stock options and stock purchase plans from employee wages for payroll tax withholding purposes.

Tax Reform and Simplification for U.S. Businesses

- AJCA 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 and allowing FTCs to be carried forward for 10 years.

- For tax years beginning after 2004, AJCA repeals the 90-percent limitation on the use of FTCs against AMT.

- AJCA 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.

Miscellaneous Provisions

- For property acquired after 2004 and before 2010, AJCA excludes from unrelated business 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.

- For a judgment or settlement occurring after the enactment date, AJCA allows an above-the line deduction for attorneys' fees and court costs incurred in connection with an unlawful discrimination claim.

Anti-Tax Shelter Provisions and Penalties

AJCA contains a numerous revenue offsetting provisions that are designed to curb abusive tax shelters. Some of these include:

- For returns and statements due after the enactment date, AJCA adds a new penalty for failing to disclose "reportable transactions" which applies without regard to whether the transaction ultimately results in an understatement of tax. The penalty is $10,000 for a natural person ($50,000 in any other case). These amounts are increased to $100,000 and $200,000 respectively for "listed transactions."

- Communications made after the enactment date with respect to tax shelters are not subject to the confidentiality provision that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

- For tax years for which the period for assessing a deficiency did not expire before the enactment date, AJCA extends the statute of limitations for a "listed transaction" if a taxpayer fails to include on any return or statement for any tax year any information with respect to a "listed transaction" which is required to be included with the return or statement. For such transaction, the statute of limitations will not expire before one year after the earlier of (1) the date on which IRS is furnished the required information, or (2) the date that a "material advisor" satisfies the list maintenance requirements requested by IRS.

- For returns due after the enactment date, AJCA repeals the prior law penalty for failure to register tax shelters and imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a "reportable transaction" (including a "listed transaction"). The penalty is $50,000 except that for a "listed transaction," the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50% of the gross income of such person related to aid, assistance, or advice provided with respect to the transaction before the date the information return that includes the transaction is filed.

- For requests made after the date of enactment, AJCA modifies the penalty for failing to maintain the required list by making it time-sensitive. A material advisor who is required to maintain an investor list and who fails to make the list available upon written request by IRS within 20 business days after the request will be subject to a $10,000 per day penalty.

- For activities occurring after enactment date, AJCA modifies the penalty on promoters of the tax shelters to be 50% of the gross income derived by the person from the activity for which the penalty is imposed.

- For tax years beginning after the enactment date, AJCA modifies the definition of "substantial" for corporate taxpayers for purposes of the accuracy-related penalty for substantial understatements so that a corporate taxpayer has a substantial understatement if the amount of the understatement for the tax year exceeds the lesser of (1) 10% of the tax required to be shown on the return for the tax year (or, if greater, $10,000), or (2) $10 million. .

- For failures to report occurring on or after the enactment date, AJCA adds an additional civil penalty of up to $10,000 for violating the requirement that citizens, residents, or persons doing business in the U.S. must file reports when they make a transaction or maintain an account with a foreign financial entity.

Other Offsetting Revenue Provisions

- Reducing tax avoidance through corporate inversions and individual expatriation.

- AJCA severely reduces the tax benefits of purchasing sport utility vehicles ("SUV") for businesses. Up to the date of enactment, business purchasers could write off up to $100,000 of the cost of a luxury SUV ($102,000 for 2004) for vehicles weighing over 6000 pounds. Under AJCA, the expense deduction has been reduced to $25,000 for most purchases. Significantly, this change took effect immediately upon the date of enactment.

- AJCA curtails the use of vehicle gift deductions for cars, boats, RVs or aircraft donated to charity. Beginning in 2005, if a charitable donation of a vehicle exceeds $500 (excluding inventory property) that is resold by the charity, the deduction is limited to the gross proceeds received by the charity upon resale.

- AJCA requires that corporations that donate noncash gifts of more than $5000 to charity must obtain a qualified appraisal.

- AJCA limits charitable contributions of intellectual property by providing the donor's initial charitable deduction is limited to the lesser of the donor's basis or the fair market value of the property. If the charity receives income from the intellectual property, the donor may then take additional deductions subject to special rules.

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Nonqualified Deferred Compensation Changes

- AJCA makes fundamental changes to the tax treatment of nonqualified deferred compensation arrangements

- Under AJCA, in order for deferred compensation to be excluded from gross income, the plan must meet certain distribution, acceleration of benefits and election requirements. If these requirements are not met, all compensation earned and deferred must be included in income for the first tax year that the nonqualified deferred compensation plan fails to meet the requirements, to the extent not subject to a "substantial risk of forfeiture" and not previously including in gross income. A twenty percent (20%) penalty will be imposed on the amount required to be included in income.

- Under AJCA, a nonqualified deferred compensation plan may not permit distributions from the plan earlier than separation from service, death, disability, a specified time (pursuant to a fixed schedule), a change in control of the corporation (to the extent allowed by the IRS), or an unforeseeable emergency.

- AJCA does not permit a plan to allow for the acceleration of benefits.

- Under AJCA, deferral elections generally must be made in the tax year preceding the year in which the services are performed or within 30 days of becoming eligible for participation.

The particular provisions of AJCA discussed in this article are but a few of the many complicated provisions enacted as part of this new legislation. The information contained herein is not intended as tax advice or to be a complete explanation of the new tax legislation or its application to any business, investment or individual tax situations. If you have questions concerning the new tax legislation or any of the specifics mentioned herein, please contact Ron Feuerstein at (703) 525-4000 ext. 288 or by email at rfeuerstein@beankinney.com.

This paper was prepared by Bean, Kinney and Korman, P.C. as a service to clients and friends of the firm. The purpose of this paper is to provide a general review of current issues. It is not intended as a source of specific legal advice. © Bean, Kinney and Korman, P.C. 2004.

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