



American Jobs Creation Act of 2004

October 22, 2004

President Bush, on October 22, 2004, signed into law the "American Jobs Creation Act of 2004" (AJCA) implementing sweeping changes to an already complex tax code. The legislation creates 274 amendments to the Internal Revenue Code with the addition of 34 new code sections. Every taxpayer will likely be affected by the new legislation. The worldwide resources of Freed Maxick & Battaglia allow us to sift through the complexities and help you identify the opportunities and challenges included in this legislation. Highlights of the law include:

- Repeal of the Extraterritorial Income Exclusion (ETI)
- Deduction for Domestic Manufacturing Activity (Manufacturers' Deduction)
- Incentives to Repatriate Foreign Earnings
- Continued Asset Depreciation Incentives
- S Corporation Simplification and Reform
- Enhanced Foreign Tax Credits
- Tax Shelter Restrictions
- Nonqualified Deferred Compensation Plan Restrictions
- Deduction for State and Local Sales Taxes
- Limitation on Charitable Contributions of Vehicles

Below is a brief summary of the highlighted changes.

Repeal of the Extraterritorial Income Exclusion (ETI)

The legislation that eventually became the American Jobs Creation Act of 2004 began as an effort to repeal an ETI subsidy ruled as an illegal export subsidy by the World Trade Organization. This ruling resulted in tariffs being imposed upon certain goods shipped from the US into the European Union. The legislation repeals the ETI subsidy and phases out the benefit (see chart below). Taxpayers will continue to benefit from the ETI through 2006.

- 2004 – 100 percent
- 2005 – 80 percent
- 2006 – 60 percent
- 2007 – 0 percent

The phase-out of ETI highlights the opportunities available by implementing an IC-DISC arrangement. Taxpayers with export sales who benefit from the ETI can maintain export benefits even after the phase-out of the ETI through formation of an Interest Charge Domestic International Sales Corporation, or IC-DISC. The IC-DISC offers a permanent tax savings of up to 20 percentage points on export profits and a wide variety of applications and flexibility for the exporting company and its shareholders. Taxpayers will need to assess the ETI transition to determine when the IC-DISC may become the preferred approach.

Deduction for Domestic Manufacturing Activity

The legislation replaces the ETI subsidy with the Manufacturers' Deduction. This is the most expansive provision in the legislation. While being called a replacement for the ETI, the Manufacturers' Deduction is actually quite more. Large numbers of taxpayers that did not qualify for the ETI benefit will qualify for the Manufacturers' Deduction. The benefit **is not based on exports**, but rather on domestic manufacturing. **Any** taxpayer manufacturing within the United States should qualify for the benefit. In addition, Congress defined manufacturing broadly including areas not generally considered manufacturing. The list includes the lease, rental, license (such as royalty income), sale, exchange, or other disposition of:

- Qualifying production property (including computer software) which was

Highlights - American Jobs Creation Act of 2004

manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States,

- Qualified film produced by the taxpayer,
- Electricity, natural gas, or potable water produced by the taxpayer in the United States,
- Construction performed in the United States,
- Engineering or architectural services performed in the United States for construction projects in the United States

The incentive ultimately reduces the effective tax rate of domestic manufacturers by providing a deduction from income phased in from 2005 through 2010 as follows:

- 2004 – 0 percent
- 2005 – 3 percent
- 2006 – 3 percent
- 2007 – 6 percent
- 2008 – 6 percent
- 2009 – 6 percent
- 2010 – 9 percent

S Corporations, LLC's, Partnerships, Estates and Trusts will pass-through this benefit to the owners. During the phase out of the ETI, taxpayers qualifying for both the ETI and Manufacturers' Deduction will benefit from both items.

Incentive to Repatriate Foreign Earnings

In an effort to encourage repatriation of profits generated overseas and spur investment and job growth within the United States, the legislation establishes a one-time dividend received deduction for C corporations on repatriated earnings of foreign subsidiaries. The deduction results in an effective 5.25 percent tax rate on the earnings returned to the United States. Earnings must be "invested" in the United States. The repatriated earnings are treated differently than normal foreign dividends in calculation of the foreign tax credit and utilization of net operating losses. Taxpayers can elect to repatriate earnings in either their last tax year beginning before October 22,

2004, or the first tax year beginning on or after October 22, 2004.

At the same time, the legislation revises rules on expatriation of companies and individuals, making it more difficult for taxpayers to move profits offshore.

Asset Cost Recovery Incentives

The legislation extends the increased expensing \$179 deduction of \$100,000 from 2005 to 2007 (subject to cost of living adjustment - \$102,000 for 2004). But it limits to \$25,000 the deduction for sport utility vehicles, which had become known as the "SUV Loophole." It also permits straight line depreciation over 15 years for certain leasehold improvements and improvements to a restaurant building made more than three years following the building's original placed in service date. Previously, those assets were depreciated over 39 years.

S Corporation Simplification and Reform

Congress has made it easier to qualify as an S Corporation. The limit on the number of S Corporation shareholders has been increased from 75 to 100. Family members within six generations of one another are now treated as one shareholder for purposes of the 100-shareholder limit. The legislation also makes it easier for certain S Corporation shareholders to use suspended losses and passive activity losses. Consistent with this theme, legislative relief is also provided for inadvertent S corporation terminations and invalid S corporation elections.

Enhanced Foreign Tax Credits

The Foreign Tax Credit carryover provisions were changed to allow a one-year carryback and 10-year carry forward of the credit. In the past, the credit was limited to a five-year carry forward. In addition, the legislation simplified the rules for utilizing foreign tax credits, making it more likely that taxpayers will receive dollar-for-dollar federal tax reductions for the foreign taxes that they do have to pay.

Tax Shelter Provisions

Partly in response to recent concerns over abusive tax shelters, the legislation adopts a new penalty for failure to disclose a reportable transaction for returns due after the date of enactment. The penalty applies even if the transaction does not result in an understatement of income. The amount of the penalty for reportable transactions (other than "listed transactions") is \$10,000 for individuals and \$50,000 for business entities. The penalty for failure to disclose a "listed transaction" is \$100,000 for individuals and \$200,000 for business entities. This penalty is in addition to any understatement of tax penalty. While the Commissioner may waive the penalty, the taxpayer has no ability to administratively appeal a penalty assessment.

Publicly traded companies must report the penalty in its SEC filings, even if the amount is not material. The legislation also modifies or creates additional penalties for understatements of tax related to reportable or listed transactions.

Nonqualified Deferred Compensation Plans

The bill provides for major changes to the rules governing the validity of deferral elections in a nonqualified deferred compensation plans. Any deferral of compensation in 2005 or later is subject to these new rules. Vested deferred compensation balances as of December 31, 2004 are not subject to these new restrictions as long as the plan is not significantly amended after October 3, 2004. The consequence of violating these new provisions is the loss of the deferral of income.

Deduction for State and Local Sales Tax

For tax years 2004 and 2005, individual taxpayers can make an election to deduct state and local general sales and use taxes rather than state and local income taxes. Taxpayers will be able to use either actual documented expenditures or a deduction based upon IRS-provided tables. There are rules for determining whether a tax will be deemed a "general sales tax" in the case of tax rate differentials and exclusions (e.g., food).

Under the election, taxpayers will not be able to deduct both state and local income and sales taxes. Taxpayers residing in states imposing both income and sales taxes will need to compare the relative deductions available in determining whether to elect a sales tax deduction over an income tax deduction. Under prior law, taxpayers in states such as Texas, which has a sales tax and not an income tax, received no deduction on their federal return for state taxes paid.

Charitable Contributions of Vehicles

The amount of the deduction for charitable contributions of automobiles, boats and airplanes with a value exceeding \$500 depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant use or improvement by that organization, the deduction is limited to the gross proceeds received from the sale. There are also new substantiation requirements for contributions of vehicles with a claimed value in excess of \$500. These limitations apply to contributions made after December 31, 2004.

Conclusion

Do not hesitate to contact your Freed Maxick & Battaglia tax advisor for assistance in taking advantage of this new legislation.