

American Jobs Creation Act of 2004

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The American Jobs Creation Act of 2004 was signed into law on October 22, 2004 with the hope that it will benefit both American workers and the companies that employ them. Originally, the principal purpose of this Tax Act was to repeal an export tax break for U.S. companies, which the World Trade Organization ruled to be illegal. However, the bill grew enormously and now includes a wide array of new tax breaks, as well as revenue provisions to pay for them. It covers everything from subsistence whaling in Alaska to an excise tax on fishing tackle boxes. It contains an estimated \$130 billion in tax breaks for businesses and individual taxpayers.

While it is difficult to say which of the several hundred provisions will have the most impact, I would like to single out a few here:

- Repeals the extraterritorial income exclusion
- Provides for a deduction for certain “manufacturing” income
- Extends the higher Section 179 amount
- Limits the Section 179 expensing of SUVs
- Allows a 15-year recovery period for certain LHIs
- Allows the expensing of the first \$5,000 of start-up and organization costs
- Contains a new itemized deduction for general sales taxes instead of deducting state and local income taxes
- Requires the recognition of gain on a principal residence acquired in a LKE if sold within five years
- Limits the charitable deduction for vehicles to the sales proceeds received by the donee

The following is a summary of these and many of the other principal provisions in this recent tax legislation.

Note: To read a more detailed description of the provisions included in this Tax Act that affect your fixed assets, see *2004 Tax Legislation and its Impact on Your Fixed Assets*.

Repeal of the Exclusion for Extraterritorial Income (ETI)

Foreign sales corporations (FSCs) were created in 1984 to provide a tax incentive for U.S. exporters. An FSC would be created overseas as a subsidiary of a U.S. company. The company’s domestic export sales were run through the FSC, which in turn earned a sales commission. This commission was exempt from federal income tax and any dividends paid by the FSC to its U.S. parent company qualified for the 100% dividends received deduction.

The European Union challenged the FSCs before the World Trade Organization (WTO). The FSCs were found to violate the WTO's rules against export subsidies. In response, Congress replaced the FSCs by passing the Extraterritorial Income Exclusion Act of 2000. The 2000 Tax Act allowed qualifying U.S. exporters to exclude certain extraterritorial income (ETI) from gross income. Again, the European Union protested and the World Trade Organization claimed that this too was an illegal trade subsidy. Shortly thereafter the European Union placed restrictions on U.S. exports by assessing penalties.

Although the American Jobs Creation Act doesn't repeal the ETI regime immediately, it provides for transitional relief starting next year. It allows 80% of the pre-act ETI benefits for transactions in 2005, 60% in 2006, and none thereafter.

Domestic Production Activities' Income

To help compensate for the lost ETI benefits, the American Jobs Creation Act provides for a deduction from income (and for AMT) of a portion of a manufacturer's qualified production activities. While aimed at assisting manufacturers, the deduction will actually be available to a wide range of businesses since the definition of a manufacturer for this purpose is greatly expanded. For the purpose of this deduction, a "manufacturer's" output includes such end products as film, electricity, natural gas, potable water, construction, engineering services, architectural services, and computer software.

Income from "qualified production activities" is the taxpayer's *domestic* production gross receipts, reduced by the sum of:

- COGS allocable to such receipts,
- Other expenses and losses directly allocable to such receipts, and
- A ratable share of expenses and losses that is *not* directly allocable to such receipts.

This new deduction is being phased in over several years. By 2010, the deduction will be 9% of the lesser of:

- Income from qualified production activities for the year, or
- Taxable income for the year (or, for AMT purposes, alternative minimum taxable income).

However, the deduction cannot exceed 50% of the W-2 wages paid by the taxpayer for the year. For the purposes of computing such wages paid, all members of an expanded affiliated group (as defined in Section 1504(a)) are treated as a single corporation.

Corporations, S corporations, individuals, partnerships, trusts and estates can claim the deduction. For qualifying corporations, the result of this deduction is to effectively reduce the top corporate rate from 35% to 32%.

For pass-through entities, the deduction is claimed at the individual level (for example, by the partner or shareholder). The total qualified production activities income is first determined at the entity level and then each individual (partner or shareholder) is allocated a portion of that income. In other words, the separate items of gross revenue and allocable expenses are not individually allocated.

To qualify for this deduction, the taxpayer does not have to export its product. Therefore, the new deduction will help many more companies than those who benefited from the ETI provisions.

This provision of the American Jobs Creation Act is being implemented by the addition of Code Section 199 and is effective for tax years beginning after December 31, 2004.

Section 179 Expense

Two-Year Extension

There is a two-year extension (for tax years beginning before 2008) for the following Section 179 expense provisions:

- The \$100,000 maximum Section 179 expense amount (adjusted for inflation)
- The investment phaseout threshold of \$400,000 (adjusted for inflation)
- The allowable revocation of a Section 179 election
- The Section 179 expensing of computer software

Limitation on Section 179 Expense for Certain Vehicles

One of the more prominent provisions of the American Jobs Creation Act is the limit placed on the amount of Section 179 expense that can be claimed on certain vehicles. Generally, you can now only claim \$25,000 of Section 179 expense on sport utility vehicles (SUVs). For this purpose, an SUV is any 4-wheel vehicle that is not a luxury vehicle (therefore it weighs more than 6,000 pounds) but does *not* weigh more than 14,000 pounds.

This closes a loophole for such vehicles that because of their weight were not considered luxury cars and businesses claimed the full Section 179 expense of \$100,000 on them.

The following are not included in the definition of an SUV for this purpose:

- Vehicles which can seat more than 9 people behind the driver,
- Vehicles with a cargo area of at least 6 feet (most trucks), and
- Vehicles with a fully-enclosed driver compartment and load-carrying space, and have no seating behind the driver's seat.

This provision is effective for property placed in service after October 22, 2004.

Community Revitalization

There are several provisions in the American Jobs Creation Act that are included in this category:

- Modifies the definition of a targeted area and low-income communities for the **New Markets Tax credit**.
- Expands the **designated renewal communities** based on the census data for 2000.
- Provides a special **low-income test for rural areas** with a high migratory population for the **New Markets Tax credit**.

S Corporation Reform and Simplification

The following provisions affect S corporations for tax years beginning after 2004:

- Family members will be treated as one shareholder for purposes of determining the total number of shareholders in an S corporation.
- Increases the maximum number of allowable shareholders to 100 (it was 75).
- When an IRA (including a Roth IRA) holds the stock of a bank that is an S corporation, the taxpayer benefiting from that IRA is deemed a shareholder of the bank.
- Allows suspended losses and deductions to be transferred to a shareholder's spouse (or ex-spouse, if incident to a divorce) and treated as if incurred by the corporation in the succeeding taxable year.
- If S corporation stock is disposed of by a qualified subchapter S trust, it will be considered a disposition by the trust's beneficiary for purposes of applying the Section 465 at-risk limitation on deductions and the Section 469 passive activity loss limitation.
- Excludes interest income and dividends paid out on investment securities from the passive investment income test for bank S corporations.
- Extends the relief from inadvertent invalid S corporation subsidiary elections and terminations.
- Allows the Treasury Secretary to issue guidance on information returns for S corporation subsidiaries.
- Provides for the repayment of loans to an employee stock ownership plan (ESOP) with a distribution from qualifying employer securities.

Other Business Incentives

There are several business incentives included in the American Jobs Creation Act:

- Phases out the **4.3-cent General Fund motor fuel excise taxes** on railroads and inland waterway transportation and repeals it in full by December 31, 2006.
- Makes several improvements relating to the **real estate investment trust (REIT) rules**. Modifies the definitions for “straight debt” and securities, as well as certain straight debt securities provisions. Includes safe harbor testing for certain rents, amends the gross income requirement, explains the consequences for failure to meet REIT requirements, and expands the circumstances under which a REIT may declare a deficiency dividend. It also provides a safe harbor for the sale of timber property.
- Creates a new General Business Credit for 50% of **qualified railroad track maintenance expenditures** during a taxable year. The credit is limited to \$3,500 times the number of miles of railroad track owned or leased by the taxpayer as of the close of the taxable year. It applies to maintenance expenditures paid or incurred in 2005 through 2007.
- Suspends the assessment of **occupational taxes relating to distilled spirits, wine, and beer**.
- Modifies the unrelated business income limitation on investment in certain **small business investment companies**.
- Allows corporations to use a per ton rate in place of the usual corporate income tax rate on income from certain **international shipping activities**.

Depreciation and Amortization

The American Jobs Creation Act contains a wide variety of provisions affecting the depreciation and amortization rules.

Recovery Period of Certain Leasehold Improvements and Restaurant Property

The American Jobs Creation Act shortens the recovery period for qualified restaurant property and leasehold improvements to 15 years (39 years for MACRS ADS) and requires the straight-line depreciation method.

Qualifying leasehold improvements have to follow Section 168(k)(3) and be nonresidential real property placed in service more than 3 years after the building is placed in service. If a lessor made the leasehold improvement, the property is qualified property as long as it continues to be held by such person (although there are certain exceptions to this, such as when the property is acquired in a like-kind exchange).

Qualified restaurant property is Section 1250 property that is an improvement to a building and is placed in service more than 3 years after the building is placed in service.

Furthermore, to qualify, more than 50% of the building's square footage must be devoted to the preparation of food and the seating for its consumption.

This provision is effective for property placed in service after October 22, 2004 and before January 1, 2006.

Bonus depreciation for Certain Aircraft

Qualifying noncommercial aircraft is eligible for bonus depreciation if placed in service before 2006. There is a list of requirements in order for the aircraft to qualify, one of which is that the aircraft must cost more than \$200,000. This is effective for property placed in service after 9/10/2001, in tax years ending after 9/10/2001.

Amortization of Sports Franchises

Extends the 15-year amortization period for intangible assets to sports franchises and any intangible asset acquired in the acquisition of such a franchise (including player contracts). (Previously Section 197 intangibles did not include sports franchises.) This provision is effective for property acquired after October 22, 2004.

Modification of MACRS Recovery Period for Motorsport Racetrack Complexes

Provides a 7-year MACRS recovery period for motorsport racetrack complexes. This includes the land improvements and support facilities (including parking lots, sidewalks, bridges, fences, and landscaping). However, this does *not* include transportation equipment, warehouses, administrative buildings, or hotels.

This provision is effective for property placed in service after October 22, 2004 and before January 1, 2008.

Other Special Recovery Periods

Alaskan natural gas pipelines are to be depreciated over 7 years, with a class life of 22 years. This is effective for property placed in service after 2013. However, qualified systems may be treated as placed in service on January 1, 2014 (even if placed in service earlier) if the taxpayer so elects to do so.

Depreciable electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines are to be included in Asset Class 49.14 (for electric), with a 20-year MACRS recovery period, and Asset Class 49.24 (for gas), with a 15-year MACRS recovery period. This is effective for property placed in service after October 22, 2004.

Consistent Amortization Periods for Start-up and Organization Costs

Changes the treatment of start-up and organizational expenditures. Allows the taxpayer to deduct up to \$5,000 of start-up expenses and \$5,000 of organizational expenses in the year in which the business begins. Each of the \$5,000 amounts is reduced (but not below zero) by the amount that the cumulative costs for each category exceed \$50,000. Start-up and organizational expenditures that are not deductible in the first year of business are amortizable over 15 years (to agree with Section 197 intangibles).

This provision is effective for start-up and organizational expenditures incurred after October 22, 2004. Any earlier start-up and organizational expenditures may continue to be amortized over 5 years, however, they must be included when calculating if the cumulative cost for each category exceeds \$50,000.

Income Forecast Method of Depreciation

Modifies the income forecast method of depreciation by including in the adjusted basis of property those costs that vary with the amount of the income from that property. However, to be included, these costs must relate to income earned by the end of the tenth taxable year after the property is placed in service.

In addition, the American Jobs Creation Act clarifies the following:

- It is the *gross income* from property that is taken into account under the income forecast method.
- Distribution costs are *not* taken into account for determining the current and total forecasted income from the property.

This provision is effective for property placed in service after October 22, 2004.

Certain Film and Television Productions

Qualifying film and television productions, whose aggregate cost does not exceed \$15 million, may be expensed in the year incurred instead of having to capitalize and depreciate them. There is a higher dollar limitation of \$20 million for productions made in certain low-income communities or distressed areas. To qualify, at least 75% of the compensation paid must be for services performed within the U. S. Furthermore, if the production is a television series, only the first 44 episodes qualify.

This provision is effective for productions beginning after October 22, 2004 and before 2009.

Deduction of Reforestation Costs

Allows an election to deduct up to \$10,000 of qualifying reforestation expenditures per year. Any expenses above \$10,000 can be amortized over 7 years (per section 194). The

Reforestation credit is repealed. This is effective for expenditures paid or incurred after October 22, 2004.

Modifies Placed-in-Service Rule for Certain Bonus Depreciation Property

In the Working Families Tax Relief Act of 2004, there is a technical correction that allows purchasers of leased property to treat the property as newly placed in service, provided that the property is purchased within 3 months of the property's initial placed-in-service date and the user of the property doesn't change. The American Jobs Creation Act adds that this also pertains to multiple units of property subject to the same lease and sold within three months, as long as the period of time between when the first unit is placed in service and when the last unit is placed in service isn't more than 12 months.

Modifies Recovery Period of Certain Leased Property

Modifies the recovery period for certain property leased to a tax-exempt entity. The affected property is qualified technological equipment, computer software and Section 197 intangibles.

The recovery period is the longer of:

- The property's class life, or
- 125% of the lease term.

Generally, this provision is effective for leases entered into after March 12, 2004.

Stock Options and Employee Stock Purchase Plan Stock Options

The American Jobs Creation Act excludes any remuneration due to the transfer (or disposition) of incentive stock options and employee stock purchase plans from FICA and FUTA taxes. In addition, such remuneration is not to be taken into account when determining Social Security benefits.

Tax Relief for Agriculture and Small Manufacturers

- Extends the **alcohol fuels income tax credit** through 2010 and eliminates the reduced excise tax rate on most alcohol-blended fuels, replacing the latter with two new excise tax credits:
 - **Alcohol fuel mixture credit**
 - **Biodiesel mixture credit**
- Creates a new General Business Credit, the **Biodiesel Income Tax Credit**.
- Taxpayers claiming tax benefits related to alcohol fuels and biodiesel fuels must follow **new information reporting** by the IRS.

- Extends the **period for replacing certain livestock** sold on account of weather-related conditions from two to four years.
- Extends the **income averaging election**, which is now available only to farmers, to fishermen. Furthermore, for AMT purposes income averaging is no longer permitted. This reduces their regular tax liability without affecting their AMT.
- **Rural letter carriers** may treat their automobile expenses, in excess of their reimbursed amount, as a miscellaneous itemized deduction, subject to the 2% floor.
- Allows qualifying whaling captains a \$10,000 charitable deduction for expenses incurred in carrying out **native Alaskan subsistence whaling**.
- Allows a deduction of up to 75% of costs incurred to comply with the **Environmental Protection Agency's (EPA) sulfur regulations**.
- Creates a new credit (five cents per gallon) for producing **low sulfur diesel fuel**.
- Creates a new General Business Credit for the production of oil and gas from **qualified marginal wells**.
- Establishes a \$10 billion fund to assist **tobacco farmers**.

Tax Reform and Simplification for U.S. Businesses

The American Jobs Creation Act contains many provisions for companies conducting business internationally:

- Changes the **current interest expense allocation rules** for computing the **foreign tax credit limitation**.
- Recharacterizes the **overall domestic loss** when a taxpayer's foreign tax credit limitation is reduced.
- Reduces the **foreign tax credit baskets** to two (there were nine): passive category income and general category income. This is effective for tax years beginning after 2006.
- Exempts certain **assets of a controlled foreign corporation** from the definition of U.S. property.
- Allow taxpayers to elect to **translate foreign income taxes** into U.S. dollars using the exchange rates at the time such taxes are paid.
- Repeals the withholding tax on **dividends paid by certain foreign corporations**.
- Repeals the rules for **foreign personal holding companies** and **foreign investment companies**.
- Extends the carryforward period of any **excess foreign tax credit** to 10 years (it was five years) and limits the carryback period to one year (it was two years).
- Reduces the withholding income tax rate (from 30% to 10%) on U.S. source dividends paid to a **Puerto Rico corporation**.
- Repeals the 90% limitation on the foreign tax credit for **AMT**.
- Establishes **incentives to reinvest foreign earnings** in the U.S.

State and Local Sales Tax Deduction

A taxpayer may elect to substitute a new itemized deduction for state and local general sales taxes instead of using the itemized deduction for state and local income taxes. There are two options:

- Deduct the actual amount paid by collecting receipts, or
- Use tables created by the Treasury Secretary. If the option to use the tables is selected, the taxpayer can also deduct sales tax paid for the purchase of a vehicle or boat.

This new deduction is also available to individuals living in states that don't have an income tax. However, you must itemize to take advantage of the deduction. Furthermore, the sales tax deduction is *not* available for calculating AMT.

Although as of the time this article was written, the IRS has not yet issued the new sales tax deduction tables, we expect the tables will provide a smaller than expected deduction. While taxpayers in states without a state income tax will, of course, claim the new deduction, it is unlikely that other taxpayers will do so. The exception to this is if a taxpayer had sizeable purchases during the last two months of the year (since no one knew to save receipts earlier in the year).

This provision is effective for tax years beginning after 2003 and before 2006.

Miscellaneous Provisions

- Creates a new category of exempt facility bond for qualified “**green buildings**” and sustainable design projects.
- Generally, tax-exempt businesses have to pay tax on any unrelated business income. The 2004 Tax Act excludes **gain or loss from the disposition of qualifying brownfield sites** from unrelated business taxable income (UBTI).
- Allows an above-the-line deduction of **attorney fees** and costs paid during certain **civil rights lawsuits**.
- Expands the **credit for electricity produced from certain renewable resources**. It adds such resources as open-loop biomass, geothermal energy, solar energy, small irrigation power, and municipal solid waste.
- Allows **certain business related credits** against both regular tax and **AMT**. The credits are the Alcohol Fuels Credit (Section 40) and the Production of Electricity from Renewable Resources Credit (Section 45).
- Includes medical strategies for **sickle cell disease** as medical assistance under the Medicaid program.

Revenue Provisions

In addition to several revenue raising provisions mentioned above (such as the Section 179 limitation on SUVs), there are a multitude of other revenue-raising provisions contained in the American Jobs Creation Act:

- There are several provisions to reduce tax avoidance through **individual and corporate expatriation**. For example, it puts in place new rules for determining if the relinquishment of citizenship is tax-motivated.
- **Penalties**
 - Creates a new penalty for failing to include in a return any required information with respect to a **reportable transaction**. An individual taxpayer may be assessed a penalty of \$10,000 or as much as \$100,000 if it's considered to constitute tax avoidance. Other taxpayers (such as corporations) may be assessed a \$50,000 penalty or \$200,000 if it's deemed to be tax avoidance.
 - An accuracy-related penalty may be imposed for an **understatement** (with a significant tax avoidance purpose) on a reportable transaction.
 - Adds an exception to the confidentiality privilege for the communication between a taxpayer and a federally authorized tax practitioner if it involves a **tax shelter**.
 - Extends the **statute of limitations** for abusive transactions that are not reported.
 - **Material advisors of tax shelters** are responsible for maintaining certain records of the reportable transactions, including a list of advisees.
 - There is an enhanced penalty on **promoters of abusive tax shelters**.
 - Adds a civil penalty for the failure to report an interest in a **foreign financial account**. A willful violation of such could receive a penalty equal to the greater of \$100,000 or 50% of the account balance (or transaction amount).
 - Includes regulation of **individuals who practice before the Department of the Treasury**. Monetary penalties may be assessed in addition to suspension, disbarment, or censure.
- A **property with a built-in loss** that is contributed to a **partnership** may be taken into account only by the contributing partner. If the contributing partner leaves the partnership, the property's adjusted basis is its FMV on the date it was contributed, eliminating the built-in loss.
- Repeals the special rules for **Financial Asset Securitization Investment Trusts (FASITs)**. FASITs were created in 1996 to facilitate the securitization of revolving, non-mortgage debt obligations. ("Securitization" is the consolidation of certain obligations that are then sold to investors for resale to the public in the form of securities.)
- Requires the recognition of gain from the **sale of a principal residence** that was acquired in a **like-kind exchange** *within five years of the sale*. The

- \$250,000/\$500,000 exclusion is not allowable. This applies to sales or exchanges after October 22, 2004.
- Allows a taxpayer to deposit cash with the IRS to be used at a later date to pay an **underpayment of income, gift, estate, generation skipping, or certain excise taxes**. This avoids an underpayment interest assessment.
 - Authorizes the IRS to set up **installment payments for less than the full amount of a taxpayer's tax liability**. The IRS must review the agreement at least every two years to determine if the taxpayer's financial status has improved sufficiently to warrant an increase in the payment amount.
 - Provides that if taxpayers **lease property to a tax-exempt entity** (including governments), the taxpayers cannot claim deductions from the lease transaction in excess of their gross income from the lease. There are certain exceptions to this rule. Any disallowed deductions can be carried forward for one year. Also, any disallowed deductions can be taken when the taxpayer disposes of its interest in the property. Generally, this provision is effective for leases entered into after March 12, 2004.
 - Allows the IRS to hire **private debt collection agencies** to locate and collect from taxpayers who have outstanding tax liabilities. The private company is authorized to set up an installment plan to spread the payment out over five years, if necessary.
 - Amends Section 7701 and modifies the definition of an **off-highway vehicle**.
 - **Taxes aviation-grade kerosene**.
 - Treats **transmix and diesel fuel blend stocks** as taxable fuel.
 - **Charitable Contributions**
 - Limits the **charitable deduction allowed for a patent** or other intellectual property (except certain copyrights and inventory). The taxpayer's initial deduction is the lesser of: taxpayer's basis in the property or its FMV. Certain additional amounts may be deducted in subsequent years based on a percentage of donee income received or accrued with respect to the property.
 - Increases reporting requirements for certain **noncash charitable contributions**. Also extends to corporations the requirement for a qualified appraisal of the property if the deduction exceeds \$5,000. If the value exceeds \$500,000, the qualified appraisal must be attached to the donor's tax return. This is effective for post-June 3, 2004 contributions.
 - **Limits the amount of the charitable deduction for vehicles** (including cars, boats, and airplanes valued over \$500) to the gross proceeds that the donee receives from the vehicle's resale as long as the donee does not use the vehicle in any significant way or materially improve the vehicle before the sale. Furthermore, the donor must substantiate the donation with a contemporaneous written acknowledgement from the donee. This must be done within 30 days of the contribution or, if resold, within 30 days of the sale. A penalty will be assessed if a donee knowingly furnishes a

fraudulent acknowledgement of a vehicle donation. This is effective for post-2004 donations.

- Includes deferred compensation in gross income under a **nonqualified deferred compensation plan** if new requirements are not satisfied and it is not subject to a substantial risk of forfeiture.
- Modifies the **straddle rules** by allowing taxpayers to identify offsetting positions, providing clarification of certain physically settled positions, and repealing the stock exception.
- Applies the **overall foreign loss recapture rule** to the sale of stock in a controlled foreign corporation by a controlling shareholder.
- Clarifies the definitions of **nonqualified preferred stock** and a **controlled group of corporations**.
- **Increases the withholding** on an employee's annual supplemental wage payments in excess of \$1 million, applying the highest income tax rate.
- Limits the employer deduction for certain **entertainment expenses**. No deduction is allowed for a nonbusiness entertainment activity or for a facility (including an airplane) used in connection with such an activity to the extent the associated expenses exceed the amount treated as compensation or that are included in income of specified individuals.