Hahn Loeser & Parks LLP

TAX ADVISORY—Summary of American Jobs Creation Act of 2004

The American Jobs Creation Act of 2004 (the "Act") was signed into law on October 22, 2004. The statute changes many areas of the Internal Revenue Code of 1986, as amended (the "Code") and will significantly affect how individuals and businesses plan their day-to-day financial activities and the structuring of major transactions. We have summarized below several highlights of the new law. We have not attempted to list all of the provisions of the Act. As most of the new law will take effect in 2005, planning prior to December 31, 2004 is prudent. We encourage you to consult with a member of Hahn Loeser & Parks LLP's Taxation & Employee Benefits Section for a more detailed discussion of the Act and how it might impact your particular business and personal decisions.

Itemized Deductions

Sales Tax Deduction

Individuals will, for 2004 and 2005, have the option of reporting either state sales taxes or state and local income taxes as itemized deductions. In the past, only a deduction for state and local income taxes was available. The new law provides that, when deducting sales taxes, taxpayers may use either actual payments or IRS-published tables to determine the amount of the deduction. This change will be helpful to taxpayers living in states which have a sales tax but no, or a limited, individual income tax, e.g., Florida, Nevada and Texas. Prior to year-end, taxpayers should analyze whether they will receive a larger tax savings from using the state and local income tax deduction or the sales tax deduction. This analysis could result in accelerating to December 2004 those purchases that are subject to state sales tax.

Charitable Contributions of Used Motor Vehicles

The Act requires that, effective 2005, the deduction resulting from a charitable contribution of an automobile, boat or airplane not exceed the amount of the recipient charity's gross proceeds from its subsequent sale of the donated item. Under the old rules, which are still applicable in 2004, the contribution would equal the fair market value of the donated item at the time of gift. Therefore, individuals who itemize deductions might want to accelerate contributions of used motor vehicles to 2004 in order to realize a larger income tax benefit.

Charitable Contributions of Intellectual Property

Under the old law, donations of patents and other intellectual property were generally deductible at fair market value. The Act changes the law such that, for contributions made after June 3, 2004, the deduction is limited to the lesser of the taxpayer's basis in the property or the property's fair market value. This applies not only to individuals who itemize deductions, but also to corporate taxpayers.

Statutory Stock Options

The Act provides that the exercise after October 22, 2004 of statutory stock options, *i.e.*, incentive stock options and options to purchase stock under an employee stock purchase plan, are not subject to FICA or FUTA taxes, nor is the employer required to withhold income taxes.

Nonqualified Deferred Compensation Arrangements

The new law includes more stringent restrictions, generally effective for tax years beginning after 2004, on an employee's ability to defer taxation on compensation income (other than through qualified retirement plans.) Under the old law, compensation deferred under a nonqualified deferred compensation plan generally would be taxed to the recipient when it is no longer subject to a substantial risk of forfeiture. We have summarized this area of the Act, and the related planning, in a separate Tax Advisory notice.

Deduction for Manufacturing and Other Qualified Production Activities

The Act added a new section to the Code that provides a deduction, for regular and alternative minimum tax purposes, for manufacturing, construction, engineering, energy production, computer software production, film and videotape production and agricultural activities taking place in the United States after 2004. This deduction is available to C corporations, S corporations, partnerships, individuals, estates and trusts. Generally, the deduction is equal to a specified percentage of income, as follows: 3% of taxable income or, in the case of an individual, adjusted gross income, for taxable years beginning in 2004 and 2005, and 6% for taxable years beginning in 2007-2009. For taxable years beginning after 2009, the deduction is calculated by multiplying 9% of the lesser of taxable income (determined without regard to this computation) and the "qualified production activities income." The deduction is further limited to 50% of the employer's wages reported on Forms W-2 for the taxable year.

S Corporations

The Act has liberalized, generally effective for tax years beginning after 2004, the S corporation requirements. For example, the maximum number of eligible shareholders has increased from 75 to 100. Also, an election may be made to treat, for purposes of counting the number of shareholders, all qualifying family members as one shareholder.

Other changes affecting S corporations include the following:

- A regular or Roth IRA may hold shares of a bank that is an S corporation, but only to the extent of the stock held by the IRA on the date of enactment.

- S corporation distributions may be used to pay down an ESOP loan the proceeds of which were used to acquire shares of the S corporation.
- Suspended S corporation losses follow transfers of S corporation stock to a spouse or former spouse made as part of a divorce.
- More relief is available when a qualified subchapter S subsidiary elections and terminations are inadvertently made in an invalid manner.

Cost Recovery Deductions

The Act provides a 15-year straight-line recovery period for qualified leasehold improvement property and "qualified restaurant property" placed in service prior to 2006 and after the enactment date. Under the old rules, such property was subject to 39-year straight-line depreciation.

The Act extends for an additional two years, *i.e.*, through 2007, the availability of immediately expensing up to $100,000 (indexed for inflation) of qualifying investments. The Act also extended the additional first-year 50% bonus depreciation (made available by other recent legislation) for purchases of certain aircraft through 2005.

The Act provides that a business owner cannot deduct more than $25,000 per year for the cost of an SUV placed in service after the enactment date.

Tax Shelter Reporting

The Act continues the efforts by the IRS to tighten up the reporting of purported "tax shelters." Penalties for failure to disclose certain categories of transactions are increased as follows: for "listed transactions," $100,000 for individuals and $200,000 for other taxpayers, and for non-listed transactions, $10,000 for individuals and $50,000 for other taxpayers. The Act also created 20-30% accuracy related penalties on the understatement of reportable transactions.

The Act requires that certain tax advisors/promoters maintain a detailed listing of information about the taxpayers that "bought" the transactions that they promote. The tax advisors/promoters must be prepared to give this information to the IRS upon request.

The Act suspends the statute of limitations for assessments on listed transactions until appropriate disclosure is made. The Act also requires disclosure in SEC reporting of penalty payments resulting from non-disclosure of listed transactions.

International Provisions

Extraterritorial Income Tax Regime

In response to an unfavorable ruling by the World Trade Organization, Congress has phased out the extraterritorial income ("ETI") regime of benefits provided to U.S. exporters. Specifically, the Act provides that a taxpayer will receive only 80% of the benefit of the ETI regime in 2005, 60% of the benefit in 2006 and that no benefit will be

available after 2006. Taxpayers with binding contacts in effect on September 17, 2003 and at all times thereafter are not subject to the loss of ETI benefits so long as the binding contract is not between the taxpayer and a related party.

Repatriation of Foreign Earnings

The Act provides U.S. companies a one-time opportunity to repatriate foreign earnings. Specifically, U.S. corporations may elect to deduct 85% of cash dividends received from a controlled foreign corporation ("CFC") during either the first taxable year beginning after the date of enactment or the last taxable year beginning before the date of enactment. As a result of this deduction, the Act provides an opportunity to bring back cash from a CFC at an effective federal income tax rate of 5.25%, rather than the current U.S. corporate rate of 35%. This tax incentive is subject to several limitations set forth in the Act..

Subpart F Income

A CFC's "subpart F income" is included in the income of the CFC's U.S. shareholders. A CFC's ownership of "U.S. property" can effectively create dividend income for the CFC's shareholders. The Act makes some changes to the definitions of "Subpart F income" and "U.S. property."

The sale of a partnership interest by a CFC occurring after 2004 will not be treated entirely as Subpart F income, so long as the CFC owns a 25% or greater capital or profits interest in the partnership. The sale of the partnership interest will be treated as Subpart F income only to the extent that a proportionate sale of the underlying assets attributable to the partnership interest represents Subpart F income.

The Act provides that the definition of "U.S. property" no longer will include securities acquired and held by a CFC in the ordinary course of its business as a dealer in securities or obligations issued by unrelated non-corporate U.S. persons.

Foreign Tax Credits

The Act made several changes to the rules for calculating a taxpayer's foreign tax credit. For example, the Act reduces the number of foreign tax credit baskets from nine to two, *i.e.*, passive category and general category, for taxable years beginning after December 31, 2006. In addition, the Act extends from five to ten years the carryover period for excess foreign tax credits and shortens the carryback period from two years to one year. The Act provides a one-time election to adopt a method of interest allocation between U.S. and foreign source income whereby the taxpayer takes into account the assets and interest expense of certain related foreign corporations. The Act also repeals the 90% limitation on the use of foreign tax credits against alternative minimum tax.

Foreign Personal Holding Companies

The Act repeals the foreign personal holding company rules and also provides that foreign corporations are not subject to the regular personal holding company rules. The Act also adds a new category of subpart F foreign personal holding company income to include personal services contract income.

Corporate Inversions

The Act imposes U.S. taxation on certain "inversion" transactions through which a U.S. corporation becomes a subsidiary of a foreign corporation or transfers its properties to a foreign corporation. Generally, under the new law, a foreign corporation will be subject to taxation as if it qualifies as a U.S. corporation if the foreign corporation acquires, after March 4, 2003, substantially all of the properties held by a domestic corporation, the former shareholders of the U.S. corporation own 80% or more (by vote or value) of the stock of the foreign corporation and, after the acquisition, the foreign corporation and companies connected to it by a greater than 50% chain of ownership do not conduct "substantial business activities" in the foreign country where the entity is created or organized.

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