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Tax Update

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The following is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

How Will the American Jobs Creation Act Affect You?

On October 22, 2004, President Bush signed a significant tax bill entitled the "American Jobs Creation Act of 2004" (the Act). The impetus for the legislation was the repeal of the most recent U.S. export tax incentive, known as the "extraterritorial income exclusion" (ETI). The World Trade Organization (WTO) previously found the ETI to be an illegal export subsidy and authorized the European Union to levy retaliatory tariffs against U.S. products until the United States repealed the ETI. The European Union began imposing a tariff on certain products earlier this year.

The Act began as a simple provision to repeal the ETI, but grew into a broad pre-election tax bill affecting a wide range of taxpayers. The following summary of the Act discusses provisions which likely affect many of our clients. The Act contains many provisions targeted at specific industries, as well as other technical provisions, that this summary does not address.

This update discusses:

- **Changes affecting employee compensation.** These changes will require employers with deferred compensation and option plans to review their plans by December 31, 2004 to ensure their effectiveness under the new law.
- **Foreign tax changes,** including the repeal of the ETI and a new "manufacturers' deduction" designed to offset the cost of repealing the ETI. The manufacturers' deduction applies to all manufacturers—even those who do not export products—and defines "manufacturer" so broadly that taxpayers who would not traditionally be considered a manufacturer may qualify for the deduction.
- **Business tax incentives** and other miscellaneous provisions likely to affect many taxpayers.
- **Provisions designed to curb the use of tax shelters.**

For specific information about the Act that is not included in this update, please contact any member of Godfrey & Kahn's Tax Team. (See Page 11 for a complete listing of Tax Team members.)

Employee Compensation Provisions

Non-qualified Deferred Compensation

In response to heightened concerns regarding executive pay packages and compensation strategies used by companies such as Enron and WorldCom, the Act has adopted an expansive definition of "non-qualified deferred compensation" and contains provisions limiting the flexibility previously available to employers offering such plans to their employees. These provisions are expected to significantly change the tax treatment of non-qualified deferred compensation, primarily with respect to deferral and distribution elections and events. The new rules governing deferred compensation apply to all amounts deferred after December 31, 2004, and to the extent there are material modifications to any deferred plans or agreements after October 3, 2004, will apply to amounts deferred under such plans before December 31, 2004. To the extent deferred compensation amounts are not "vested" by December 31, 2004, the new rules will also apply to such amounts.

Types of Covered Plans or Agreements
The Act defines non-qualified deferred compensation as "any plan or arrangement that provides for the deferral of compensation," other than those specifically excluded from the definition. This broad definition applies to plans and arrangements offered to either employees or independent contractors and has been interpreted to cover common arrangements such as:

- Traditional elective deferred compensation (both salary and bonus deferral programs);
- Non-qualified defined benefit plans (supplemental executive retirement plans (SERPs));
- Section (§) 457(f)[1] arrangements (for non-profit organizations);
- Stock appreciation rights (SARs), restricted stock units (RSUs) and phantom stock;
- Discounted stock options; and
- Severance plans.

Those types of plans specifically excluded from the definition by the Act include certain qualified employer plans, vacation leave, sick leave, compensatory time, disability pay, and death benefit plans. In addition, the Conference Report accompanying the Act indicates that Treasury will issue guidance specifically excepting both fair market value stock options and employee stock purchase plans meeting the requirements of §423 from the new rules. The Conference Report also indicates that annual bonuses or other compensation amounts that are paid within 2½ months after the close of the taxable year in which the relevant services were performed should not be treated as deferred compensation.

Taxation of Non-qualified Deferred Compensation
Under the Act, unless the arrangement or plan meets all of the requirements under new §409A and is operated in accordance with such requirements, the employee must include compensation in income upon the later of: (1) the time the compensation is deferred or (2) where applicable, when the compensation is no longer subject to a substantial risk of forfeiture (generally, when vested). In addition to the income inclusion rule, an employee receiving compensation under a plan that does not comply with §409A or is not operated in accordance with §409A will be subject to additional income tax equal to 20% of the compensation required to be included in income at such time. Finally, the employee will be subject to interest and penalties if the compensation is included in income any later than as provided under the Act. A plan failure may occur if the plan does not contain the provisions required by §409A or is not operated in accordance with its rules and such failure will cause all "affected employees" to be subject to the income inclusion and interest rules of §409A. Thus, there is a strong incentive for employers and employees to ensure that all non-qualified deferred compensation complies with the new rules under §409A.

Deferral Election Requirements Under §409A
Under §409A, compensation must be deferred prior to the calendar year in which the services will be performed by the employee, with two exceptions. First, newly eligible employees will have 30 days after they become eligible to elect to defer future compensation earned after the election is made. Second, with respect to "performance-based compensation" (variable and contingent on the satisfaction of pre-established performance goals) in which the performance period is at least 12 months, employees must elect to defer such compensation at least 6 months before the end of the performance period.

Distributions Under §409A
Deferred compensation may not be distributed except upon:

- Death of a participant;
- Disability of a participant (as defined in §409A);
- Separation of service for most participants;
- 6 months after a separation of service for "key employees" of publicly traded companies[2];

[1] All section (§) references refer to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
[2] "Key employees" of publicly traded companies include: (1) up to 50 officers earning annual compensation in excess of $135,000 (adjusted for inflation); (2) 5% or more owners; and (3) 1 % or more owners earning annual compensation in excess of $150,000.

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- A specified time or schedule (specified at the date of the deferral);
- Change of control (as defined by the regulations—expected within 60 days of October 22, 2004); or
- Unforeseeable emergency (as defined in §409A).

Section 409A does not permit the acceleration of scheduled payments and only permits distributions to be made upon the occurrence of any one of the aforementioned events. This means that early withdrawal of proceeds from non-qualified deferred compensation plans no longer will be permitted if the plan is subject to the new rules.

Changes to distribution elections, common in many deferred compensation plans, are now severely limited by §409A. Participants electing to make changes in their distribution elections are only permitted to do so if the election would further defer (acceleration is not permitted) the payments under the plan or arrangement and the election must:

- Be in effect for at least 12 months;
- Be made 12 months in advance (if the original deferral was made to a certain date); and
- Must defer the payment for at least 5 years from the date of the originally scheduled payment.

Funding via Rabbi Trusts
Most deferred compensation plans only involve an unsecured promise by the employer to pay in the future. Some employers have established "rabbi trusts" to hold assets from which deferred amounts may be paid. Typically, the amounts are beyond the reach of management but available to unsecured creditors in the event of a bankruptcy. Section 409A taxes a participant's deferred compensation as of the earlier of the date that the plan provides that assets will become restricted if there is a change in the employer's financial health or the date the assets are so restricted. Regulations are expected to define a "change in the employer's financial health." In addition, §409A taxes a participant whose deferred compensation is funded through the use of offshore rabbi trusts unless substantially all the services performed by the participant are performed in the foreign jurisdiction. Taxation of such amounts would also require the 20% additional compensation inclusion, as well as applicable interest, as discussed above.

Reporting and Withholding
Under the Act, amounts required to be included in income under new §409A are subject to income tax withholding and reporting rules. In addition, amounts deferred, even though not currently subject to income tax, will need to be reported on Form W-2 or 1099 in the year deferred. Treasury is expected to provide guidance that will except from these rules both (1) *de minimis* amounts; and (2) amounts under non-account balance plans that are not reasonably ascertainable. Amounts that are not reasonably ascertainable will need to be reported when they first become reasonably ascertainable.

Transition Rules and Grandfather Provisions
The provisions of the Act will apply to all amounts deferred after December 31, 2004 and to amounts deferred before such date if the non-qualified deferred compensation plan or arrangement is materially modified after October 3, 2004, unless such modification is made in order to comply with future guidance to be issued by Treasury. A "material modification," as explained in the Conference Report, includes the addition of any benefit, right or feature to a pre-existing plan or arrangement. In addition, deferred compensation that is not vested by December 31, 2004 will be subject to the new rules. Amounts deferred before December 31, 2004 under existing plans will not be subject to the new rules, as long as no material modifications are made to those plans or arrangements. Treasury is required to issue guidance by December 21, 2004 in order to (1) allow participants to terminate participation or cancel outstanding elections for deferral after December 31, 2004; and (2) allow employers to make amendments to existing plans that would bring such plans into compliance with the new rules.

Planning Point—Identify All Existing Deferred Compensation Arrangements. Due to the effective date of December 31, 2004, we encourage employers to identify all plans and arrangements in which compensation may be deferred under the broad definition of §409A and to evaluate whether changes in current plans or adoption of new plans will be required or advisable under the new rules.

Planning Point—Avoid Amendments to Any Plans or Arrangements Until Further Guidance is Available. Employers should avoid making any changes to existing plans that would cause those plans to lose their grandfathered status. Note that accelerating the vesting of outstanding deferred compensation awards would be a material modification.

Planning Point—Consider Adopting New Plans/Freezing Old Plans. As the penalties for non-compliance with the new rules could potentially cause all amounts deferred under a plan to be subject to current taxation, penalties and interest, consider adopting new deferred compensation plans for post-December 31, 2004 deferrals. This would help to avoid subjecting any previously deferred amounts to the new rules.

Planning Point—Bonus Deferral Elections for Amounts Paid in 2005. Continue to collect bonus deferral elections for bonuses earned in 2004 but not paid until 2005. To the extent participants

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are required to remain employed in 2005 in order to receive such bonuses, these bonuses are subject to the new rules. Although it remains unclear whether all such bonuses can be effectively deferred under the new rules, it is possible that Treasury will issue interim guidance with respect to such bonuses, thus allowing them to be deferred. Consider making such bonus deferral elections contingent on the amount of income not being subject to income tax in 2005.

Planning Point—Ensure Plan Compliance by Adopting Internal Controls. As the consequences of failing to maintain a plan in accordance with §409A can be severe and may affect all participants, it will become increasingly important for employers to adopt internal control procedures to avoid inadvertent plan failures.

Planning Point—Consider Postponing All Distributions in Publicly Traded Companies for 6 Months After a Separation of Service. In order to avoid tracking "key employees" of publicly traded companies throughout the life of a deferred compensation plan, public companies may wish to postpone all distributions until 6 months after a separation of service so they do not inadvertently cause a plan termination by making early distributions, thereby affecting all "key employees" in that plan. Privately held companies expecting to become publicly traded may wish to consider adopting similar policies, in order to avoid any concerns with amendments to distribution elections in the event they later become publicly traded.

Planning Point—Expect Further Guidance and Changes. It will be necessary for a number of issues to be clarified by regulations. While a significant amount of guidance regarding the transition rules is expected to be issued before year end, there still will be a significant number of issues in connection with the new rules that will remain unclear at year-end. Advisors should inform both the Board of Directors and Compensation Committee members, as well as participants, that amendments may need to be made to compensation plans based on future guidance, especially for employers adopting new deferred compensation plans.

Increase in Supplemental Wage Withholding Rate for Amounts in Excess of $1 Million

Under the Act, the withholding rate for supplemental wages paid to employees by an employer (currently 25%) is increased to 35% for all supplemental wages paid to an employee in a calendar year in excess of $1 million. Supplemental wages generally include bonuses, commissions, amounts includable in income due to stock option exercises, vesting of restricted stock, etc. The increased wage withholding rate will apply to payments made after December 31, 2004. All entities in a controlled group are treated as a single employer for purposes of determining whether amounts are in excess of $1 million.

Planning Point—Review Tracking Systems within Payroll Departments. All supplemental wage payments made to an employee within a controlled group must be aggregated for purposes of determining when amounts are in excess of $1 million. This may involve a revision of current payroll tracking systems for many employers.

Exclusion of Incentive Stock Option and Employee Stock Purchase Plan Stock Options from Wage Withholding

Under the Act, the exercise of incentive stock options (those granted under a qualified plan meeting the requirements of §422), the transfer of shares under employee stock purchase plans (those qualified under §423) and any disqualifying dispositions of stock issued under either type of plan, are not subject to payroll taxes and the employer is not required to withhold income taxes upon such events. The IRS had previously issued a moratorium on the collection of such payroll taxes, and the Act has now codified the moratorium. Note that that Act has not revised an employer's reporting obligation with respect to such events on an employee's Form W-2.

Creation of Manufacturing Deduction and Foreign Provisions

Repeal of Exclusion for Extraterritorial Income and Creation of Manufacturers' Deduction

ETI Repeal

The extraterritorial income (ETI) regime was the latest version of a number of export incentives built into the U.S. tax system. Prior incentives included the domestic international sales corporation and the foreign sales corporation (FSC). In the late 1990s the European Union found the FSC system to be an illegal subsidy. In 2000, the ETI replaced the FSC and provided an exclusion from gross income for income attributable to certain foreign receipts. Shortly after the introduction of the ETI, the WTO found this regime to be illegal. The Act repeals the ETI, effective for transactions after December 31, 2004.

The Act includes transition relief providing for a 100% exclusion for transactions during 2004, 80% during 2005 and 60% for 2006. The exclusion for extraterritorial income remains in effect for certain transactions under a binding contract between the taxpayer and an unrelated person that was in effect on September 17, 2003 and at all times thereafter.

Planning Point—Given the repeal of the ETI, and the 15% rate on dividends that is currently in place, certain taxpayers who are exporters may benefit from the "Interest Charge Domestic International Sales Corporations" or IC DISCS.

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Manufacturers' Deduction
As compensation for the loss of the ETI, the Act provides an incentive to U.S. manufacturers. The provisions target both domestic and international sales transactions for domestic production. For tax years beginning after 2004, the Act allows a taxpayer to deduct a percentage of the lesser of a taxpayer's:

- Qualified production income, or
- Taxable net income (without regard to this deduction).

The applicable percentage of the deduction is 3% for years 2005-2006, 6% for years 2007-2009, and 9% for years 2010 and beyond. The deduction is limited to 50% of wages paid by the taxpayer during the year. The deduction is available for most taxpayers including C corporations, S corporations, partnerships (including LLCs), sole proprietorships, cooperatives, estates and trusts.

Qualified production income is equal to net income from U.S. manufacturing; production (including the production of electricity, natural gas and potable water); growth (including food production, food storage and food processing); extraction activities; film production; and construction, engineering and architectural services. It does not include retail food or beverage sales, distribution of electricity, natural gas or potable water and certain related party receipts.

Planning Points—Manufacturing Definition. The Act defines "manufacturing" very broadly to include activities not commonly considered manufacturing activities. This includes such activities as producing electricity, providing architectural services or even roasting coffee beans (but not brewing coffee). Many service industries in particular should consider restructuring operations in order to maximize any partial benefits that may be available under the new deduction. In addition, businesses that have manufacturing activities and non-manufacturing activities should properly track costs associated with manufacturing in order to maximize the deduction. Also, given the 50% wage limitation, the choice of business entity may affect the amount or availability of the credit (*e.g.,* the IRS does not consider partners in a partnership to be employees, suggesting that in certain cases an S corporation with similar activity will yield a higher deduction). We anticipate significant additional guidance from the IRS further defining business activities that qualify as "manufacturing" as well as other guidance for this new law.

Temporary Incentive for Repatriation of Dividends

The Act provides a temporary incentive to bring foreign earnings back to the United States by reducing the effective tax rate on dividends from foreign subsidiaries from 35% to 5.25%. The ability to use the reduced rate, however, is subject to a number of limitations: The dividends (1) must be paid in cash; (2) must exceed the taxpayer's average repatriations for a 5-year base period (average of 5 last years, excluding the high and low years); (3) must be invested in the United States pursuant to a "domestic reinvestment plan;" (4) are limited to the greater of $500 million or certain foreign investments shown on the financial statements; and (5) must be paid to the parent of a controlled foreign corporation. The provision is effective, at the taxpayer's election, for either the taxpayer's last taxable year beginning before October 22, 2004 or the taxpayer's first taxable year beginning during the 1-year period starting on October 22, 2004. For calendar year taxpayers this means either 2004 or 2005.

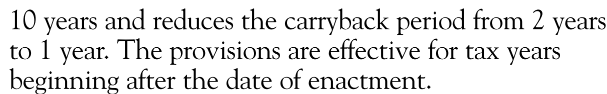
Planning Point—Timing of Election. There may be a significant advantage to making the election in 2004 or 2005, depending on the circumstances. Also consider the ability to pay such dividends, the foreign tax credit implications, and whether there are any foreign tax costs associated with paying the dividends. In certain cases, the impact of the exclusion on the foreign tax credit may make the election inadvisable.

Foreign Tax Credit

Recharacterize Overall Domestic Loss
If a taxpayer has an overall domestic loss in a year in which it has foreign source income (FSI), the loss offsets the FSI and negatively impacts a taxpayer's ability to claim foreign tax credits (FTCs) in the future. The Act allows a taxpayer to undo the harmful effect of such losses by allowing a taxpayer to recharacterize future U.S. source income (USI) as FSI to the extent of the lesser of: (1) the amount of unrecharacterized overall domestic losses from prior years, or (2) 50% of the taxpayer's USI for such succeeding year. The provisions apply to overall domestic losses sustained in a taxable year beginning after December 31, 2006.

Foreign Tax Credit Baskets
As noted above, a U.S. taxpayer's ability to use the FTC is limited to the U.S. tax liability on FSI. This FTC limitation is currently broken down into and applied separately to nine various categories known as baskets. The Act simplifies the limitation by reducing the number of baskets to two, passive and general. Items of income that are taxable in a foreign jurisdiction but not in the United States are considered general category income. The provisions are generally effective for taxable years beginning after December 31, 2006.

Foreign Tax Credit Carryover Period
The Act extends the FTC carryover period from 5 to



10 years and reduces the carryback period from 2 years to 1 year. The provisions are effective for tax years beginning after the date of enactment.

AMT Limitations
Effective for tax years beginning after 2004, the Act eliminates the 90% limitation on the use of foreign tax credits against the alternative minimum tax.

Interest Expense Allocation Rules
A U.S. taxpayer's FTC is generally limited to the U.S. tax liability on FSI. In determining FSI, an allocation of interest expense is made to or from FSI. Currently, taxpayers allocate interest based upon a ratio of gross domestic assets to gross foreign assets. For domestic asset purposes, all assets of domestic affiliates are treated as assets of a single corporation. With respect to foreign subsidiaries, the stock of the subsidiaries is taken into account rather than the assets. The Act permits a one-time election to treat all members of a worldwide group as a single corporation and to thereby use foreign assets in the ratio calculation. The provisions apply for taxable years beginning after December 31, 2008.

Other Foreign Tax Credit Provisions
The Act modifies or repeals other rules relating to the FTC such as: (1) look-through for dividends from "10/50" companies for purposes of classifying income into baskets; (2) translation of foreign taxes in a non-functional currency; (3) treating deemed payments from outbound transfers as royalties for FTC purposes; and (4) clarifying that indirect tax credits flow through to partners in a partnership.

Subpart F and Other Anti-Deferral Matters

Repeal of Anti-Deferral Regimes
The Code provides various sets of rules designed to prevent U.S. taxpayers from shifting certain types of income offshore so as to defer taxes on such income. The Act repealed two such anti-deferral regimes: the foreign personal holding company rules and the foreign investment company rules. Deferral techniques prohibited under these rules are still generally prohibited under different rules that previously overlapped with the repealed rules. The provisions are generally effective for tax years beginning after December 31, 2004.

Look-Through for Sales of Partnership Interests
Under current rules, the sale of a partnership interest by a controlled foreign corporation creates foreign personal holding company income, resulting in immediate taxation to the holders. Under the Act, upon a sale of a 25% or greater interest, the income is characterized by looking through to the partnership's assets. Thus, the sale will not necessarily trigger immediate taxation, depending on the types of assets held by the partnership. The provisions are generally effective for tax years beginning after December 31, 2004.

Other Subpart F Reforms
The Act revised or repealed the provisions relating to foreign shipping and aircraft income, foreign hedging transactions in commodities and the definition of active financing for purposes of the controlled foreign corporation (CFC) rules. These provisions have various effective dates.

Corporate Inversions

Exportation Entities
The Act limits the ability of U.S. companies to move offshore by either characterizing such offshore entities as domestic and/or imposing a larger toll charge on the move offshore. These provisions are effective on taxable years ending after March 4, 2003.

Insider Compensation
To further discourage moves offshore, the Act imposes an excise tax on certain stock-based compensation held by insiders during the period surrounding a move offshore. The excise tax rate is 15% and is generally effective March 4, 2003.

Other Foreign Provisions

Built-In Loss Assets
The Act requires that assets brought into the United States in an otherwise tax-free transaction be stepped down to their fair market value if there is an overall inherent loss in the assets. These rules are effective for transactions after October 22, 2004.

Liquidations of Holding Companies
Under prior law, a liquidation of a U.S. holding company to a foreign parent generally was not subject to U.S. withholding tax as it was normally viewed as a payment in exchange for stock rather than a dividend. The Act treats such payments as dividends for certain holding companies that have been in existence for less than 5 years. The rules apply to any distributions in complete liquidations occurring after October 22, 2004.

Business Tax Incentives

Expensing of Acquired Property

Extension of Increased Limits on Expensing Acquired Property
Pursuant to §179, taxpayers may elect to expense, rather than depreciate, the cost of qualifying property acquired for use in their trade or business. In 2003, Congress amended §179 to increase the amount of qualifying property which a taxpayer may expense from

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$25,000 to $100,000 (adjusted for inflation). Under prior law, §179 phased out the amount allowed to be expensed on a dollar-for-dollar basis after the cost of the qualifying property placed in service exceeded $200,000. The 2003 amendments increased the phaseout threshold to $400,000 (adjusted for inflation). In addition, the 2003 amendments expanded the definition of qualifying property to include off-the-shelf software placed in service in a taxable year beginning after December 31, 2002 and before January 1, 2006. The above changes were applicable for tax years beginning after December 31, 2002 and before January 1, 2006. The Act extends these changes for two additional years, through taxable years beginning before January 1, 2008.

Planning Point—Timing of Purchases. Taxpayers should structure acquisitions of §179 property in order to maximize use of the temporary $100,000 limitation. That is, to the extent practicable, taxpayers should avoid making annual purchases of §179 property in excess of $400,000 so they can take advantage of the full amount of the $100,000 deduction in the years it is available.

Limitation on §179 SUV Deduction

The §179 expensing election discussed above can be claimed for passenger autos and sport utility vehicles only if the property is used over 50% in a trade or business. In addition, depreciation is capped for "passenger autos." The definition of "passenger autos" does not include heavy sport utility vehicles (*i.e.*, those weighing 6,000 pounds or more). Thus, prior to the Act, the full cost of most heavy sport utility vehicles used 100% for business was fully deductible in the year of purchase.

The Act provides that the cost of any sport utility vehicle that can be taken into account for purposes of the §179 expense election is limited to $25,000. If a taxpayer makes a §179 election for a sport utility vehicle costing more than $25,000, the taxpayer can depreciate the remainder of the basis of the sport utility vehicle pursuant to the normal depreciation rules. For purposes of the limitation, "sport utility vehicle" means any four-wheeled vehicle: (1) that can be used to carry passengers over public streets, roads or highways; (2) that is rated 6,000 or more pounds gross vehicle weight but less than 14,000 pounds gross vehicle weight; (3) that is not designed to have a seating capacity of more than nine persons behind the driver's seat; (4) that is not equipped with a cargo area of at least six feet in interior length that is not an open area or designed for use as an open area; and (5) that does not have an integral enclosure, fully enclosing the driver compartment and load carrying device.

Depreciation and Amortization Provisions

Leasehold Improvements

The Act temporarily reduces the recovery period for "qualified leasehold improvement property." Generally, non-residential real estate and improvements thereto are depreciated over 39 years. The Act provides for qualified leasehold improvement property to be depreciated over 15 years using the straight-line method. The 15-year recovery period is applicable to qualified leasehold improvement property placed in service after October 22, 2004 and before January 1, 2006.

Qualified leasehold improvement property is any improvement to the interior portion of non-residential real property if the improvement is made under or pursuant to a lease for the use of the tenant. The improvement must be placed in service at least 3 years after the date the original building was first placed in service. If the improvement is made by the lessor, subsequent owners of the property will not be entitled to the shortened recovery period.

Restaurant Property

The Act also temporarily reduces the recovery period for "qualified restaurant property." Qualified restaurant property is defined as an improvement to real property that is placed in service more than 3 years after the building was first placed in service and more than 50% of the building in which it is placed is devoted to the preparation of and seating for the consumption of prepared meals. Like qualified leasehold improvements, qualified restaurant property placed in service after October 22, 2004 and before January 1, 2006 shall be depreciated over 15 years using the straight-line method. Prior to enactment, restaurant property, like other non-residential real estate, was depreciated over 39 years.

Non-Commercial Aircraft

In 2002, Congress amended the Code to temporarily provide businesses an opportunity to deduct "bonus first-year depreciation." Bonus first-year depreciation allows a taxpayer to immediately deduct up to 50% of the cost of qualifying acquired property, then depreciate the remaining basis of the property over its normal depreciation life. The bonus first-year depreciation provisions apply to property placed in service before January 1, 2005 for most types of property, but extended to certain property placed in service before January 1, 2006. The Act extends the placed in service deadline to January 1, 2006 for certain non-commercial aircraft.

Leasing Arrangements with Tax-Exempt Entities

Generally, depreciation of property used in a trade or business is determined using the modified accelerated

cost recovery system (MACRS). However, certain property must be depreciated using an alternative depreciation system (ADS). ADS uses straight-line depreciation and generally provides for longer recovery periods than those under MACRS. Depreciation of tax-exempt use property must be computed using ADS depreciation and the recovery period for tax-exempt use property subject to a lease must be at least 125% of the lease term. Tax-exempt use property is generally tangible personal property that is leased to a tax-exempt entity (however, there exists an exception for certain short term leases). Prior law provided specific recovery periods for certain types of property, regardless of whether the property was tax-exempt use property. The Act provides that the recovery period for tax-exempt use property subject to a lease may not be less than 125% of the lease term, regardless of whether a shorter term has been specifically assigned under ADS. The Act extends the application of the minimum recovery period to computer software and certain other intangible property leased to a tax-exempt entity. The amendment applies to leases entered into after March 12, 2004.

Furthermore, the Act limits a taxpayer's deductions related to tax-exempt use property to the amount of gross income derived from the tax-exempt use property in any given year, subject to certain exceptions. These rules are generally applicable to leases entered into after March 12, 2004.

In addition, the Act provides special provisions that deny the benefit of the like-kind exchange rules or involuntary conversion rules to certain exchanges or conversions involving tax-exempt use property. This provision applies to property exchanged or converted after October 22, 2004.

Organizational and Start-Up Expense Provisions

Under prior law, no current deduction was allowed for organizational expenses or start-up expenses of a corporation or partnership. Taxpayers had been able to elect to amortize such expenses over a period of not less than 60 months (beginning in the month business began). The Act provides that a corporation or partnership can currently deduct up to $5,000 of organizational expenses and $5,000 of start-up expenses. The amount of currently deductible organizational expenses is reduced (but not below $0) by the amount by which the cumulative amount of organizational expenses exceeds $50,000. A similar reduction applies to start-up expenses. Any organizational or start-up expenses that are not currently deductible must be amortized over 15 years.

S Corporation Reform and Simplification

Effective for taxable years beginning after December 31, 2004, the Act liberalizes the requirements for making an S election and addresses several issues attendant to operating an S corporation.

Requirements for S Elections

The Act makes it easier to qualify as an S corporation in three ways. First, it expands the number of shareholders that an S corporation may have from 75 to 100.

Second, the Act allows all members of a family to count as a single shareholder for purposes of the 100 shareholder limitation. Generally, the Act defines members of a family to include a common ancestor and all his or her descendants (as well as their spouses), so long as the common ancestor is no more than six generations removed from the youngest generation of shareholders.

Third, the Act allows an IRA to hold shares in a bank with an S election if the IRA held the stock on October 22, 2004. The individual for whose benefit the IRA is held is treated as the shareholder and must meet the eligibility requirements for S corporation shareholders. The IRA will pay unrelated business income tax on the earnings. The Act also permits an IRA to sell bank stock held by the IRA on October 22, 2004 to the IRA beneficiary without incurring the tax on prohibited transactions under §4975, provided the sale is pursuant to an S election; the sale is for fair market value and under fair terms; the IRA does not pay commissions or other expenses in connection with the sale; and the stock is sold in a single cash transaction not more than 120 days after the S election is made.

Other S Corporation Issues

The Act addresses a wide range of issues that arise in operating an S corporation.

Pursuant to the Act, an unexercised power of appointment is disregarded in determining whether a person is a potential current beneficiary of an electing small business trust (ESBT). Also, the Act extends from 60 days to 1 year the period during which an ESBT can dispose of S corporation stock once an ineligible stockholder becomes a potential current beneficiary.

The Act provides that suspended losses or deductions with respect to S corporation stock transferred to a taxpayer's spouse (or former spouse incident to a divorce), which carry over to the transferee spouse. Under prior law, there was no provision for the treatment of suspended losses or deductions when a shareholder transferred stock to a spouse.

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The Act provides that disposition of S corporation stock owned by a qualified subchapter S trust is treated as a disposition by the trust beneficiary for purposes of applying the at-risk and passive activity loss limitations.

The Act allows a C corporation's employee stock ownership plan (ESOP) to apply dividends on its employer stock to repay an ESOP loan used to acquire qualified employer securities, regardless of whether the employer stock has been allocated to a participant's ESOP account. Prior to the Act, the Code's prohibited transaction rules precluded a leveraged ESOP from repaying a loan with S corporation distributions attributable to allocated shares. For a dividend paid on any employer security allocated to a participant, the ESOP must provide that employer securities with a fair market value of not less than the amount of the dividend will be allocated to the participant for the year in which the dividend would have been allocated to the participant. This provision applies to distributions on S corporation stock that are made after December 31, 1997.

In calculating the passive investment income of banks, bank holding companies and financial holding companies for purposes of the S corporation tax on excess passive income, the Act excludes interest income and dividends on assets required to be held by such entities. Examples of assets that such entities are required to hold include stock in the Federal Reserve Bank, Federal Home Loan Bank, Federal Agricultural Mortgage Bank or participation certificates issued by a Federal Intermediate Credit Bank.

The Act provides that the IRS may waive inadvertently invalid qualified subchapter S subsidiary elections and terminations. This mirrors the relief already provided for inadvertently invalid S corporation elections and terminations.

Miscellaneous Provisions

Cancellation of Indebtedness Income Realized on Satisfaction of Debt with Partnership Interest
When a partnership satisfies a debt (recourse or non-recourse) with a capital or profits interest, the Act requires the partnership to recognize discharge of indebtedness income as if the satisfaction was made with cash equal to the fair market value of the interest. Any cancellation of indebtedness income recognized by the partnership is allocated to partners that held interests immediately before the debt was satisfied.

Definition of Controlled Group of Corporations
For purposes of the corporate tax brackets, the accumulated earnings credit and the minimum tax, the Act modifies the definition of a brother-sister controlled group. It defines such a control group as 2 or more corporations if 5 or fewer persons who are individuals, estates or trusts own stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of shares of all classes of stock of each corporation. The foregoing calculation shall take into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. For other provisions, the prior standard, which additionally requires that the same 5 or fewer persons possess at least 80% of the voting power or stock value, but not necessarily in identical ownership in each corporation, is retained. The provision is effective for taxable years beginning after October 22, 2004.

Contributions of Patents and Similar Property
Under prior law, donations of patents were generally deductible at fair market value. The Act limits the charitable contribution deduction available for the contribution of patents or other intellectual property donated to a charitable organization to the lesser of the taxpayer's basis in the property or the fair market value of the property. In addition, if the donated property provides income to the donee in excess of the amount originally taken as a charitable contribution, the taxpayer may be able to claim a charitable contribution deduction based on a specified percentage of the qualified donee income accrued or received by the donee and attributable to the donated property. This provision applies to contributions made after June 3, 2004.

Contributions of Motor Vehicles, Boats and Airplanes
The Act limits the contribution deduction available for the donation of automobiles, boats and airplanes for contributions valued at more than $500. If the donee sells the donated property without a significant intervening use or material improvement, the deduction is limited to the gross proceeds received by the donee from the sale of the property. Additional documentation must be provided by the donee disclosing the sale proceeds or, in the event the property is not sold, describing the use of the property. This provision applies to contributions made after December 31, 2004.

Increased Reporting Requirements for Non-Cash Charitable Contributions
The Act provides for increased reporting requirements for non-cash charitable contributions. The Act extended to C corporations the requirement that qualified appraisals be obtained for non-cash contributions of $5,000 or more. In addition, for contributions of $500,000 or more, the qualified appraisal must be attached to the tax return.

This provision applies to contributions made after June 3, 2004.

Required Reporting of Taxable Mergers and Acquisitions
For transactions occurring after October 22, 2004, if a corporation acquires the stock or assets of another corporation in which one or more shareholders of the selling corporation are required to recognize gain, the purchasing corporation (or the target if so required by the IRS) must file an IRS information return with respect to the transaction.

Payment of Estimated Tax Required for §338(h)(10) Deemed Asset Sale
The Act clarifies that there is no exception to the payment of estimated tax for a deemed asset sale under §338(h)(10). If there is an agreement at the time of the qualifying stock purchase to make a §338(h)(10) election, the estimated tax payment is computed based on the asset sale. The change is effective for transactions occurring after October 22, 2004.

Deduction of State and Local General Taxes in Lieu of State and Local Income Taxes
For tax years beginning after December 31, 2003 and before January 1, 2006, the Act allows taxpayers who itemize their deductions to elect to deduct state and local general sales and use taxes instead of state and local income taxes. At the taxpayer's election, the taxpayer may deduct:

- Actual general sales and use tax paid by accumulating receipts, or
- A deduction based on IRS published tables plus actual taxes paid on motor vehicle and boat purchases.

The IRS tables will be based on average consumption, on a state-by-state basis taking into account filing status, number of dependents, adjusted gross income and each state's applicable rate of sales tax.

This election may particularly appeal to taxpayers in states without income taxes: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. The deduction remains a non-deductible item for alternative minimum tax purposes.

Attorneys' Fees for Certain Litigation
The Act permits an above-the-line deduction for attorneys' fees and court costs paid after October 22, 2004 with respect to any judgement or settlement of unlawful discrimination claims and certain claims against the government occurring after this date. The deduction may not exceed the amount includable in gross income from the judgement or settlement for the applicable tax year. Any remaining fees and costs limited by gross income can still be taken as a miscellaneous itemized deduction. The above-the-line treatment also makes the fees and costs deductible for alternative minimum tax purposes.

Deduction Related to Personal Use of Company Aircraft and Other Entertainment Expenses
The Act overrules several court cases that allowed a company to deduct expenses associated with personal benefits to executives, such as personal flights of employees on corporate aircraft, in excess of the income reported by the employees. For expenses related to entertainment-arrangement or recreation-related goods, services or facilities provided to officers, directors and 10% or more owners incurred after October 22, 2004, company deductions are limited to the amount of income reported by such persons.

Tax Shelter Provisions

Treasury promulgated a list of tax avoidance transactions ("reportable transactions") in early 2003. As described below, the Act imposes meaningful penalties and provides the IRS with procedural advantages to discourage taxpayers from entering into such transactions.

Failure to Disclose Penalty
The Treasury Regulations require that taxpayers disclose on their tax returns their participation in the following types of reportable transactions: (1) listed transactions that have been identified by the IRS as being principally motivated by tax avoidance; (2) transactions offered to a taxpayer under conditions of confidentiality; (3) transactions that provide taxpayers with contractual protection if the intended tax consequences of the transactions are not sustained; (4) transactions that generate losses that exceed certain thresholds; (5) transactions with significant book-tax differences; and (6) transactions involving a brief asset holding period.

The Act imposes new penalties on taxpayers for failing to disclose their involvement in reportable transactions: $10,000 for individuals ($100,000 for listed transactions) and $50,000 for taxpayers ($200,000 for listed transactions). For reportable transactions other than listed transactions, the IRS may rescind the failure-to-disclose penalty if doing so would promote compliance with the tax laws and effective tax administration. The failure-to-disclose penalty applies in addition to any other applicable penalties and regardless of whether the taxpayer's participation in the reportable transaction results in a tax underpayment. The penalty applies to tax returns due after October 22, 2004. The Act also mandates that a taxpayer subject to SEC reporting disclose the payment of such penalty in its SEC filings.

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Accuracy-Related Penalty
Notwithstanding adequate disclosure, if a taxpayer participates in a listed transaction or any other type of reportable transaction with a significant tax-avoidance purpose, the IRS may impose a separate accuracy-related penalty equal to 20% of the "tax understatement." A tax understatement generally equals the increase in a taxpayer's income tax resulting from the IRS's redetermination of tax liability. The IRS will waive an understatement penalty if the taxpayer satisfies a reasonable cause exception, which requires adequate disclosure, reliance on substantial authority for the tax treatment and the taxpayer's reasonable belief that the tax treatment was proper. The accuracy-related penalty increases to 30% (without a reasonable cause exception) if a taxpayer fails to disclose either a listed transaction or a reportable transaction with a significant tax-avoidance purpose. In addition to the 30% penalty, a taxpayer is prohibited from deducting any interest paid or accrued on an understatement of tax attributable to such non-disclosed transactions. The accuracy-related penalty applies to tax years ending after October 22, 2004.

Extension of Statute of Limitations
If a taxpayer fails to disclose a listed transaction or a transaction is identified as a listed transaction prior to the expiration of the applicable statute of limitations, the Act extends the statute of limitations to 1 year after the IRS receives notification of the taxpayer's participation in such transaction. Importantly, the statute of limitations may only be extended with respect to the undisclosed listed transaction and not for other items on the return.

Obligations of Material Advisors
Under former law, tax shelter organizers were required to register "tax shelter" transactions prior to the day interests in the shelter were first offered for sale. Generally, tax shelters included certain confidential corporate transactions as well as transactions in which the ratio of gross deductions to amount invested exceeded two to one.

The Act repeals the tax shelter registration provisions in favor of a requirement for each "material advisor" to file an information return with respect to each reportable transaction. Such information returns must describe the transaction and the expected potential tax benefits. Material advisors must also maintain a list, subject to IRS review, of all reportable transactions in which they assisted. A material advisor generally refers to any person who provides any material assistance in organizing, selling or carrying out any reportable transaction in which the material advisor derives gross income, directly or indirectly, in excess of certain threshold amounts ($50,000 in the case of a reportable transaction in which substantially all of the benefits are provided to natural persons; $250,000 in all other cases). These reporting obligations are effective for any material advice provided after October 22, 2004. In the event of non-compliance, material advisors face significant penalties subject only to the IRS's rescission authority.

Planning Point—Reporting Requirements. The Act's definition of material advisor could obligate attorneys, accountants, investment bankers and other service providers involved in

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certain reportable transactions to file information returns. Service providers who advise on large transactions should implement internal controls to ensure that all reportable transactions for which the service provider was a material advisor are properly reported. Finally, this potential reporting requirement raises confidentiality concerns as well as attorney-client privilege issues.

Promoter Penalty

The Act imposes a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in a tax shelter arrangement for making false and fraudulent statements as to any material matter relating to a tax shelter. The penalty equals 50% of the promoter's gross income from the transaction.

Failure to Report Interests in Foreign Financial Accounts

Schedule B of Form 1040 prompts taxpayers to report any interests in foreign accounts or trusts. For a non-willful failure to disclose an interest in a foreign financial account, the Act imposes a penalty of up to $10,000, which may be waived with a showing of reasonable cause. The Act increases the penalty for willful failures to report interests in foreign financial accounts to the greater of $100,000 or 50% of either the account balance at the time of the violation (in the case of a failure to disclose an account) or the transaction amount (in the case of a failure to report a transaction).

Monetary Penalties on Tax Advisors

Previously, the IRS had the authority to suspend or disbar from IRS practice a taxpayer representative (including an attorney, CPA or enrolled agent) who was incompetent, disreputable, violated IRS practice rules or acted with an intent to defraud willfully and knowingly misleads or threatens a person being represented. Under the Act, the IRS has the additional ability to censure taxpayer representatives and to impose monetary sanctions on such individuals and their employers. The monetary penalty cannot exceed the gross income derived from the conduct giving rise to the penalty and may be in addition to suspension, disbarment, or censure.

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