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Summary of the American Jobs Creation Act of 2004

On October 22nd, the President signed the American Jobs Creation Act of 2004 (the 2004 Jobs Act). Unlike most recent tax legislation, the new law is “revenue neutral.” It includes about \$140 billion worth of good news for taxpayers in the form of new and expanded breaks. These are offset by about \$140 billion worth of bad news in the form of loophole closers and revenue raisers.

There are literally hundreds of changes. Many are arcane and will not affect you, your family, or your business. However, a good number of the changes may make a difference to you and yours. This letter covers the provisions we think are most likely to fit into the latter category.

Tax Changes Affecting Individuals

New Deduction for State and Local Sales Taxes

The 2004 Jobs Act allows individuals the option of claiming an itemized deduction for either general state and local sales taxes or state income taxes, but not both. This change is intended to put those who live in jurisdictions with low or no personal income taxes on an equal footing with those who are able to deduct state and local income taxes. Under the new rule, you can choose to deduct actual sales tax amounts or instead deduct predetermined amounts from IRS tables (plus actual amounts incurred from purchases of motor vehicles, boats, and certain other items to be specified by the IRS in future guidance). The new deduction is only available for tax years beginning in 2004 and 2005 (unless Congress takes further action to extend the break).

Tax Planning Impact: This change is only helpful if you itemize deductions. Unfortunately, you cannot claim the new deduction under the alternative minimum tax (AMT) rules.

New Deduction for Certain Attorney Fees and Costs

The 2004 Jobs Act provides a new above-the-line deduction for contingent attorney fees and related costs paid by or on behalf of claimants in legal actions involving claims of unlawful discrimination, certain claims against the federal government, and private causes of action under the Medicare Secondary Payer statute. This favorable change

applies to fees and costs paid after 10/22/04, in connection with judgments and settlements occurring after that date.

Tougher Rules for Deferred Compensation Arrangements

The new law includes a batch of complicated rules intended to make it more difficult for employees to enter into valid deferred compensation arrangements. The new rules generally require deferred compensation elections to be made before the beginning of the year in which the related compensation will be earned. However, elections to defer performance-based compensation can be made as late as six months before the performance period ends. New restrictions are imposed on when deferred compensation payouts can be received and on elections to change the form of payment or delay payments. These generally unfavorable new rules are effective for amounts deferred under nonqualified deferred compensation arrangements in tax years beginning after 2004.

Tax Planning Point: The new rules will require significant planning and compliance efforts to gain the desired tax benefits under deferred compensation arrangements. Contact us if you have questions.

Charitable Contributions—Vehicles, Boats, and Planes

Under the new law, deductions for charitable contributions of vehicles, boats, and airplanes for which the claimed value exceeds \$500 will depend on how the donated asset is used by the recipient charity. If the charity sells the asset without any significant intervening use or material improvement, the donor's deduction is generally limited to the amount of gross sales proceeds. (When this rule applies, the actual fair market value of the donated asset is irrelevant.)

The new law also imposes strict substantiation requirements for contributions of vehicles, boats, and planes when the claimed value exceeds \$500. Under these rules, no deduction is allowed unless the donor receives a contemporaneous written acknowledgment from the charity. That document must meet strict new guidelines. To be considered contemporaneous, the acknowledgment must be provided to the donor within 30 days of the date of the sale of the asset. A charity can be charged a penalty if it knowingly furnishes a false or fraudulent acknowledgment or if it knowingly fails to furnish an acknowledgment that meets all the new requirements. The penalty can be as high as \$5,000. To the extent required by the IRS, charities must disclose to the IRS information included in acknowledgments given to donors. These unfavorable changes are effective for contributions made after 2004.

Tax Planning Impact: If you are considering making a charitable donation of a vehicle, boat, or plane in the near future, you should probably try to do so before year-end. That way, you can deduct the full fair market value of the donated asset, and the recipient charitable organization will only have to comply with the less-strict substantiation requirements imposed under current law.

Charitable Contributions—Other Noncash Donations

Under the 2004 Jobs Act, stricter donor reporting is required for certain contributions of property other than cash, inventory, or publicly traded securities. Specifically, all C corporations are now required to obtain a qualified appraisal for donated property if the claimed deduction exceeds \$5,000 (this rule has long applied to individuals). If the claimed deduction for a donation of property other than cash, inventory, or publicly traded securities exceeds \$500,000, a qualified appraisal must be attached to the donor's tax return. This requirement applies whether the donor is an individual, partnership, or corporation. These unfavorable changes apply retroactively to contributions made after 6/3/04.

Charitable Contributions—Donations of Patents and Similar Intellectual Property

The new law provides that if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to charity, the taxpayer's initial deduction is limited to the lesser of the property's tax basis or its fair market value. The donor may be allowed to deduct additional amounts in later years based on a specified percentage of income received by the charity from the donated property. These additional amounts are calculated using sliding-scale percentages that decline over the years. No deduction is permitted for any income received by the charity after the expiration of the legal life of the patent or intellectual property. The donor must obtain an annual written substantiation from the charity of the amount of any income generated by the donated property. In turn, the charity must file an annual information return with the IRS to report the income and other required information. Under these rules, additional charitable deductions are not available for patents or other intellectual property contributed to most private foundations. These changes apply retroactively to contributions made after 6/3/04.

Business Tax Changes

The main reason for the 2004 Jobs Act was to repeal the existing regime of federal income tax breaks for foreign sales corporations (FSCs) and extraterritorial income (ETI). Repeal was necessary because the World Trade Organization had ruled that the existing FSC/ETI regime amounted to an illegal export subsidy by the U.S. government.

New Deduction for Domestic Producers

To offset the loss of the FSC/ETI tax breaks, the new law creates a 9% federal income tax deduction for domestic producers. The new write-off is phased in according to the following schedule: 3% for tax years beginning in 2005 and 2006, 6% for years beginning in 2007–2009, and the full 9% for years beginning in 2010 and beyond. The deduction equals the applicable percentage (3%, 6%, or 9%) multiplied by the lesser of: (1) qualified production activities income for the year or (2) taxable income for the year. However, the deduction cannot exceed 50% of wages for the year.

The new deduction is not limited to C corporations. It's also available to S corporations, partnerships, sole proprietorships, cooperatives, estates, and trusts with qualifying domestic production activities. Nor is the deduction limited to taxpayers that export to foreign countries. In fact, it's available to many businesses that will be completely unaffected by the repeal of the FSC/ETI regime.

The definition of "qualified production activities" is very broad. Therefore, many taxpayers will qualify for the new write-off including (but not limited to) those engaged in the following industries in the U.S.: traditional manufacturing of tangible personal property, construction, civil engineering and architectural services for construction projects, software production, and farming.

Tax Planning Impact: Because the potential application of the new deduction is so broad, it may be possible for your business to qualify even though it seems unlikely on first blush. If you have questions, please give us a call.

Major Overhaul of Tax Rules for Foreign Income

The new law makes big (and mostly favorable) changes in the tax rules for businesses with foreign income. The foreign tax credit rules are liberalized and streamlined. There is a temporary 85% dividends received deduction for U.S. corporations to encourage them to bring home cash from controlled foreign corporations (this amounts to a limited "tax holiday"). The new law includes many other provisions that may be important to taxpayers with foreign income.

Tax Planning Impact: Give us a call if you think your business may be affected by any of these changes.

Depreciation Changes

Extension of Current Section 179 Deduction Rules. The new law extends the current maximum Section 179 deduction (\$102,000 for 2004, indexed for inflation) for an additional two years—through tax years beginning in 2007. For tax years beginning in 2008 and beyond, the maximum deduction is scheduled to fall back to only \$25,000 unless Congress takes further action.

Reduced Section 179 Deduction for SUVs. The new law places a \$25,000 limit on the Section 179 deduction for SUVs with gross vehicle weight ratings of 14,000 pounds or less. Previously, SUVs with gross vehicle weight ratings of more than 6,000 pounds could qualify for the full deduction (\$102,000 for 2004). This unfavorable change only affects SUVs placed in service after 10/22/04. However, the new rule doesn't apply to vehicles that meet certain exceptions. For example, many pickups with full-sized beds are unaffected. Vehicles that fall under the tax-law exceptions still qualify for the full Section 179 deduction, as long as they have gross vehicle weight ratings in excess of 6,000 pounds.

Tax Planning Impact: The idea of buying a new “heavy” SUV to be used over 50% for business before the end of 2004 still makes great sense—even if the placed in service date is after 10/22/04. The combination of the \$25,000 Section 179 deduction plus 50% first-year bonus depreciation plus regular first-year depreciation means your business can still immediately deduct a large percentage of the new vehicle’s cost on this year’s return. However, time is of the essence because the 50% first-year bonus depreciation break will expire after December 31st. Remember: first-year bonus depreciation is only available for new (not used) vehicles.

15-year Depreciation for Leasehold Improvements. Under current law, most leasehold improvement costs for nonresidential real property must be depreciated over 39 years. The new law establishes a 15-year depreciation period (using the straight-line method) for qualified nonresidential leasehold improvement property. This favorable new rule applies to qualified leasehold improvements placed in service after the date of enactment and before 2006.

Tax Planning Impact: Qualified leasehold improvements placed in service in 2004 also qualify for 50% first-year bonus depreciation. However, the bonus depreciation break will expire after 12/31/04.

15-year Depreciation for Restaurant Improvements. Current law requires most restaurant building improvements to be depreciated over 39 years. The new law provides a 15-year depreciation period (using the straight-line method) for qualified restaurant property placed in service after 10/22/04 and before 2006. This change has the beneficial side effect of making qualified restaurant improvements eligible for 50% first-year bonus depreciation.

Tax Planning Impact: Immediate action is required to take full advantage of this favorable change, because the first-year bonus depreciation break will expire after December 31st. 2004 tax returns can be affected.

Big Changes for S Corporations

Number of Shareholders. The new law allows family members to be treated as one shareholder for purposes of determining the number of shareholders of an S corporation. Even better, the new law increases the maximum allowable number of shareholders from the current 75 to 100. These changes are effective for tax years beginning after 2004.

Suspended Losses after Divorce. The new law allows S corporation losses that were suspended due to basis limitations to be transferred (along with the related S corporation shares) to a spouse or former spouse in divorce. This change is effective for transfers after 2004.

New Rules for Start-up and Organizational Expenditures

Under current law, taxpayers can amortize business start-up expenditures (expenses incurred before the operation is up and running) over 60 months. They can also amortize corporate and partnership organizational expenditures over the same period. Under the new law, taxpayers can immediately deduct up to \$5,000 of start-up costs and up to \$5,000 of organizational expenditures in the tax year in which the business begins. However, each \$5,000 allowance is reduced by the amount of cumulative costs in excess of \$50,000. Startup and organizational expenditures that are not deductible in the year the business begins must be capitalized and amortized over 15 years on a straight-line basis. This change is effective for expenditures incurred after 10/22/04.

No Federal Payroll Taxes on Exercise of Statutory Stock Options or Dispositions of Related Stock

Incentive stock options (ISOs) and options granted under employee stock purchase plans are referred to as statutory options. Back in 2002, the IRS announced it would not attempt to assess FICA or FUTA taxes or require federal income tax withholding upon exercises of statutory options or upon dispositions of stock acquired by exercising such options. However, this taxpayer-friendly policy was not permanent. The new law makes it permanent for stock acquired by exercising statutory options after 10/22/04.

New Breaks for Agriculture, Timber, and Fishing

Beyond the new deduction for qualified domestic production activities, the 2004 Jobs Act includes a host of new tax benefits for the agriculture, timber, and fishing industries. These include the following (among many others).

- Coordination of the farm income averaging rules with the alternative minimum tax (AMT) rules. This change prevents the benefits of income averaging from being cancelled out by the AMT rules. The new rule is retroactively effective for tax years beginning after 2003. Therefore, calendar-year 2004 returns can be affected.
- The replacement period to qualify to defer tax on gains from certain forced early sales of livestock due to drought, flood, or other weather-related conditions is extended from two to four years. Also, the new law liberalizes the rules regarding what qualifies as similar replacement property. These changes are retroactively effective for tax years for which the unextended tax return due date is after 12/31/02. Therefore, these changes can affect calendar-year 2004 returns. Also, you may want to amend 2002 and 2003 returns to take advantage of the favorable new rules.
- In presidentially declared disaster areas, affected cash-basis taxpayers now have up to four years after the end of the disaster event year to elect a one-year deferral of income from early forced sales of livestock. This change is retroactively effective for tax years for which the unextended tax return due date is after

12/31/02. Therefore, it can affect calendar-year 2004 returns. Also, you may want to amend 2002 and 2003 returns to take advantage of the favorable new rule.

- Extension of income averaging (previously available only to farmers) to fishermen. This change is retroactively effective for tax years beginning after 2003. Therefore, calendar-year 2004 returns can be affected.
- Capital gains treatment is allowed for outright sales of timber by landowners. This change is effective for sales after 2004.
- The new law permits fishermen to use income averaging, which was previously only allowed for farmers. This change is retroactively effective for tax years beginning after 2003. Therefore, calendar-year 2004 returns can be affected.

Conclusions

You now have a better understanding of the tax law changes we think are most likely to affect you, your family, and your business. However, the American Jobs Creation Act of 2004 includes many other new provisions that we have not mentioned in this letter. If you have questions or want more information about the new law, please give us a call.

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