Cross-Border Tax Alert

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THE AMERICAN JOBS CREATION ACT OF 2004

The *American Jobs Creation Act of 2004* recently passed Congress and was recently signed into law by President Bush. What began as a bill to compensate exporters for repeal of a controversial $50-billion tax based trade subsidy has ballooned into a $145-billion business tax break.

The new law passed the House on October 7, 2004, by a 280-141 vote, and was approved by the Senate on October 11, 2004, by a 69 to 17 majority.

The new law benefits U.S. manufacturers, multinational operations, agribusiness and energy companies, small businesses, farmers, partnerships and real estate investors. To balance such tax benefits, the new law has revenue-raising provisions that affect both individuals and business taxpayers.

Many provisions in the new law require immediate action to maximize benefits and avoid problems. Effective dates vary depending on the specific provisions, thus adding to the overall confusion.

The revenue-raising provisions, including ETI repeal, are expected to bring in $145 billion, making the net cost of the new law $0. However, the revenue provisions are permanent, while most of the tax-cuts have a temporary life.

In sum, the *American Jobs Creation Act of 2004*:

- Repeals the FSC/ETI regime;
- Creates a new tax deduction for "manufacturers";
- Continues enhanced small business expensing for two more years;
- Reduces the SUV loophole;
- Accelerates depreciation for leasehold and restaurant improvements;
- Makes significant changes to S corps rules;
- Simplifies international taxation;
- Gives farmers tax relief;
- Boosts tax shelter penalties;

- Tightens vehicle donation rules;
- Modifies tax treatment for deferred compensation and other employee benefits
- Etc.

REPEAL OF EXTRATERRITORIAL INCOME TAX REGIME

The extraterritorial income (ETI) regime is the latest in a line of export-related benefits the U.S. tax system has provided to taxpayers, beginning with the domestic international sales corporation (DISC) regime, and immediately preceded by the foreign sales corporation (FSC) regime.

The current dispute before the World Trade Organization (WTO) started in 1997 when the European Union (EU) charged that the FSC regime was an illegal export subsidy. In October 1999, the WTO ruled for the EU, which gave the United States, under the trade organization's rules, one year to either repeal or modify the FSC rules.

In November 2000, Congress passed and President Clinton signed into law the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, which replaced the FSC rules with an exclusion from gross income for extraterritorial income (a taxpayer's gross income attributable to foreign trading gross receipts). Generally, the exclusion is available to individuals, domestic corporations, certain foreign corporations, and passthrough entities such as S corporations and partnerships.

The EU quickly challenged the new legislation, arguing that it only perpetuated the problems with the FSC. In January 2002, the WTO held that the ETI regime, like the FSC before it, was an illegal export subsidy, and authorized the EU to impose retaliatory sanctions of up to $4 billion a year against U.S. exports until the ETI rules were repealed. The sanctions were instituted in March 2004 at a rate of 5 percent and climbed by an additional percentage point each month. They reached a rate of 12 percent in October 2004, and would have risen to a maximum of 17 percent in March 2005 had Congress not agreed to repeal the ETI regime.

The new law gradually repeals the ETI regime, starting next year. Taxpayers will be able to claim 100 percent of their ETI benefits in 2004, 80 percent in 2005, 60 percent in 2006, and zero percent (a complete repeal) thereafter.

The full exclusion generally remains in effect for taxpayers that had entered into binding contracts in effect on September 17, 2003.

The tax rate cut for manufacturers (see below) is intended to replace this repealed subsidy. Those that can meet the rather broad definition of "manufacturer" will do well; those that are entitled to both the extraterritorial income exclusion as it is being phased-out, and the manufacturers' reduced tax rate as it is being phased-in, will benefit even further.

Many service industries in particular may need to restructure operations to maximize partial benefits under the new tax regime and to meet the definition of a "manufacturer".

MANUFACTURERS' DEDUCTION

To replace the ETI regime, Congress has created a new deduction for manufacturers. The most expensive provision in the new law, the deduction will effectively reduce the corporate income tax rate for domestic manufacturing three percentage points, from a top rate of 35 percent down to 31.85 percent. Lawmakers have defined "manufacturers" (and their underlying "production activities") very broadly.

Many domestic producers qualify for the new deduction, including, but not limited to:

- Traditional manufacturing;
- Construction;
- Engineering;
- Energy production;
- Computer software;
- Films and videotape; and
- Processing of agricultural products.

When fully phased in by 2010, the deduction will be equal to nine percent of the lesser of:

(1) qualified production activities income for the year, or
(2) taxable income for the year.

The new deduction, however, starts at a transition percentage of three percent for 2005 and 2006; and will rise to six percent for 2007 through 2009. The deduction is limited to 50 percent of the W-2 wages paid by the taxpayer during the tax year.

The Act provides relief to a wide variety of entities, including C corporations, partnerships, S corporations, sole proprietorships, cooperatives, and estates and trusts. In the case of corporate taxpayers that are members of certain affiliated groups (defined by substituting 50 percent for 80 percent control) the manufacturers' deduction is calculated by treating the group as a single taxpayer, and allocated among members in proportion to each member's respective amount of qualified production activities income.

Taxpayers also may use the new deduction for AMT purposes.

The new deduction goes far beyond counterbalancing the FSC/ETI exclusion. In fact, some estimate that the majority of companies able to take the deduction were never affected by the FSC/ETI exclusions. Others note, that many manufacturers in the United States that are experiencing the greatest challenges are also reporting significant tax and financial losses. These taxpayers -- arguably those in greatest need of assistance -- will realize little or no benefit from additional deductions.

All qualifying U.S."manufacturers," whether or not they export, are eligible for this new deduction. Supporters of this deduction, argue that the deduction will create new jobs and grow the economy more than enough to offset the initial cost.

Many businesses may be surprised that they qualify as "manufacturers."

Treasury and the IRS are going to have to draft regulations explaining what business activities qualify as "manufacturing" for the new deduction.

SMALL BUSINESS EXPENSING AND DEPRECIATION

In 2002, Congress raised the threshold for small business expensing from $25,000 to $100,000. This special treatment is reduced when the cost of qualifying property placed in service for the tax year exceeds $400,000. The enhanced treatment was designed as a temporary measure to stimulate the economy, with the initial intention that the limit would fall back to $25,000 in 2006. This new legislation extends the higher small business expensing amounts through 2007[1].

Note that off-the-shelf computer software placed in service in taxable years beginning before 2008 is included as qualifying property.

It would appear that Congress may make the higher amounts permanent. The provision is effective on the date of enactment.

Depreciation

The Act provides for a 15-year recovery period, using straight-line depreciation, for qualified leasehold improvements to nonresidential real property, placed in service after the date of enactment, and before January 1, 2006. If the lessor made the improvement, subsequent owners generally cannot use the 15-year period to depreciate the improvement.

Prior law required that a "qualified" leasehold improvement or addition be depreciated using straight-line depreciation over the same 39-year period as nonresidential real property.

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[1] The threshold is indexed for inflation starting in 2004. It is $102,000, with a $410,000 property cap for 2004. This new law provides indexing to 2007 for small business expensing.

A qualified leasehold improvement is an improvement to the interior of a building, made by either the lessor or lessee and placed in service more than three years after the building is placed in service.

The new law also provides a 15-year recovery period and straight-line depreciation for *qualified restaurant property* placed in service after the date of enactment and before January 1, 2006. The property also becomes eligible for first year bonus depreciation.

Qualified restaurant property is a building improvement placed in service more than three years after the building was placed in service. The restaurant must use more than half of the building's square footage for such property improvements to meet the definition of *qualified restaurant property.*

Note that the shorter recovery period and the availability of bonus depreciation for restaurant property should produce much larger tax savings in the first year.

If a leasehold improvement or restaurant property qualifies as tangible personal property under existing law, taxpayers may be better of using cost segregation to depreciate the elements separately over a shorter recovery period (using bonus depreciation and an accelerated depreciation method).

SUV deduction

Currently, because the vehicle caps on depreciation do not apply to cars or trucks weighing more than 6,000 pounds, taxpayers can deduct up to the full cost of the SUV immediately as a section 179 deduction. Now, the deduction for vehicles weighing not more than 14,000 pounds (for e.g. SUVs) is capped at $25,000, effective for property placed in service after the date of enactment.

Nevertheless, owners of heavy SUVs still fare better than other vehicle owners. First-year deduction amounts for vehicles under 6,000 pounds currently are capped at $2,960 (excluding bonus depreciation[2] for vehicles which expires this year).

S CORPORATION REFORM

The Act updates and simplifies rules for S corporations, and expands the eligibility rules for using these entities. Specifically, the Act includes provisions to:

- Allow members from up to six generations of a family to elect to be treated as one shareholder.

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[2] Pursuant to tax legislation enacted in 2002 and 2003, certain property was eligible for an additional first-year depreciation deduction (bonus depreciation) of up to 50 percent of the qualified property's adjusted basis. Generally, eligible property must have been placed in service before January 1, 2005, to qualify for a bonus depreciation deduction. Certain types of property, however, may still qualify for a bonus depreciation deduction if placed in service before January 1, 2006.

- It also provides relief for inadvertent invalid elections or terminations of an election to have a family treated as one shareholder. (The provision is effective for taxable years beginning after December 31, 2004.)

- Increase the number of permissible S corporation shareholders from 75 to 100. (The provision is effective for taxable years beginning after December 31, 2004).

- Permit the eligible shareholders of a bank that is an S corporation to include in either an IRA or Roth IRA, but only to the extent of the bank stock held by the IRA on the date of enactment. The provision also, under certain conditions, would allow a sale of the bank stock by the IRA to an IRA beneficiary. (The provision is effective on the date of enactment.)

- Allow an S corporation shareholder to transfer losses, suspended due to lack of basis, to a former spouse incident to a divorce. (The provision is effective for taxable years beginning after December 31, 2004.)

- Allow beneficiaries of a qualified subchapter S trust, following the disposition of S corporation stock, to use suspended losses under the passive- activity and at-risk rules. (The provision is effective for transfers after December 31, 2004.)

- Allow banks and bank holding companies to exclude from passive investment income, for purposes of applying the passive investment income rules, all interest income and dividends on assets required to be held by the bank or company, including stock. (Effective Date -- The provision is effective for taxable years beginning after December 31, 2004.)

- Allow the IRS to provide relief in the case of inadvertently invalid qualified subchapter S subsidiary elections and terminations. (The provision is effective for elections and terminations after December 31, 2004.)

- Provide authority to the IRS to issue guidance on information returns for qualified subchapter S subsidiaries. (The provision is effective for taxable years beginning after December 31, 2004.)

- The Act permits S corporation distributions on allocated shares in an employee stock ownership plan (ESOP) to be used to repay the outstanding ESOP loan. This is a prohibited transaction under current law. The ESOP must allocate shares with a value equal to the distribution to the participant's account (The provision retroactively applies to distributions made after December 31, 1997).

In conclusion, the S corporation is among the fastest growing business entities in the U.S., competing with partnerships (which includes LLCs) for the lead. The new provisions may boost the popularity of S corporations. Individuals contemplating starting a business or reorganizing an existing business will need to have a good look at the new S corporation rules, especially if the business owners are family members.

A husband and wife may want to include one or more children or grandchildren as S corporation shareholders. Under the new law, they can treat all of them as one shareholder.

STATE SALES TAX DEDUCTION

The Act gives individuals who itemize deductions a choice of deducting either their state and local income taxes or their state and local sales taxes, if greater. This provision provides relief to taxpayers residing in states that do not levy state income taxes.

Taxpayers may determine their deductible state and local sales tax by using: (1) actual receipts on all purchases, or (2) tables published by the IRS[3]. Those using the tables may also deduct sales tax paid on the purchase of motor vehicles, boats, and other items specified by Treasury. This temporary provision will be of most interest to residents of states that have no personal income tax. These states are: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. In addition, New Hampshire and Tennessee tax only dividends.

Note that the new sales tax deduction is available not only to taxpayers living in states without an income tax, but also to those in any state who find that sales taxes paid during the year (for example, for several major purchases) exceed their state income tax liability for the year. Again, the new deduction is available only for taxpayers that itemize their expenses. This election has been made available for tax years beginning after 2003 and before 2006.

It is important to keep in mind that the alternative minimum tax (AMT) may eliminate any benefit provided by the sales tax deduction provision. Recall that taxpayers are not allowed to deduct state and local taxes when computing the AMT.

INTERNATIONAL TAX REFORM

The new law contains a host of provisions targeted at taxpayers with international business operations.

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[3] Per the conference report Congress doesn't expect the Treasury to have the tables ready before the 2005 filing season. What estimates will be allowed for 2004 returns without these table remains to be seen.

For example, Congress approved reducing the number of foreign tax credit baskets from nine to two. The two new baskets are passive category income and general category income. The new law also delineates some financial services income as general category income and allows taxpayers to make a temporary election about certain creditable foreign taxes.

Other important actions impacting on foreign tax credits and international taxation include:

- Application of a re-sourcing rule to U.S. source income when a taxpayer's foreign tax credit is reduced because of an overall domestic loss.

- Application of look-through treatment under subpart F for sales of partnership interests.

- Clarification of certain deem-paid foreign tax credits.

- Creation of new exceptions from the definition of U.S. property for certain shareholders in controlled foreign corporations.

- An election for taxpayers required to translate foreign income taxes at the average exchange rate to use exchange rates at the time the taxes are paid.

- Elimination of secondary withholding tax on dividends paid by some foreign corporations.

- Similar treatment of interest paid by foreign partnerships and foreign corporations.

- Taxpayer-friendly treatment of certain regulated investment company (RIC) income where dividends are received by foreign persons and their estates.

- Repeal of foreign personal holding company and foreign investment company rules.

- Modification of temporary exceptions from subpart F personal holding company income for banking, finance and similar business activity.

- Relaxation of the rules requiring foreign investors receiving REIT distributions to file U.S. returns.

- Reduction in the withholding tax rate on U.S. source dividends paid to a Puerto Rico corporation.

- More generous tax treatment for some gambling winnings of nonresident aliens.

Foreign tax credit carryover/carryback

The new law also calls for a 10-year carryover of the foreign tax credit and a one-year carryback period. Current rules generally permit a two-year carryback and a five-year carryover.

AMT treatment

Under current law, the AMT foreign tax credit is generally limited to 90 percent of the taxpayer's AMT. Congress voted to abolish the 90-percent limitation. The new treatment is effective for tax years beginning after December 31, 2004.

This is definitely good news for U.S. citizens living in Canada, with large taxable incomes who in the past essentially were effectively doubled taxed due to this applicable US AMT.

TAX SHELTERS AND ABUSIVE TRANSACTIONS

Enhanced penalties

Congress has approved increasing penalties for promoters and investors failing to disclose their participation in abusive transactions. Taxpayers, other than individuals, failing to disclose a reportable transaction risk a $50,000 penalty. For individuals, the penalty is $10,000. If the shelter is a "listed transaction," the penalty rises to $200,000 ($100,000 for individuals). The new law also creates a new accuracy-related penalty for reportable and listed transactions. Promoters also could be liable for a penalty equal to 50 percent of the gross income derived from the abusive transaction.

Also to note, is that the IRS has been given discretion in applying such penalties.

Confidentiality rules

The new law relaxes the confidentiality rules for communications between taxpayers and practitioners about shelters and extends the statute of limitations to capture more abusive transactions.

"Material advisors"

Promoters – and individuals and businesses doing business with them – risk tougher sanctions. All "material advisors" failing to file information returns about reportable transactions will be sanctioned. "Material advisors" also will be penalized for not maintaining lists of investors in abusive transactions. These new provisions will generally be effective after the date of enactment.

Foreign leasing arrangements.

The new law limits the depreciation and amortization periods for intangibles leased to tax-exempt entities, especially with leases involving computer software. The new law also limits the deductions allowable in connection with property used by governments or other tax-exempt entities.

Repatriation of foreign earnings

Lawmakers have been very concerned over how to spur companies to reinvest their foreign earnings in the U.S. The new law includes a provision to make certain dividends received by a U.S. corporation from a controlled foreign corporation eligible for an 85-percent dividends-received deduction (equivalent to apply a 5.25-percent tax rate to such didvidends, assuming application otherwise of the top corporate rate).

Taxpayers must elect whether to take the deduction for dividends received either during the first tax year before enactment of the new law or during the last tax year before enactment. Generally, the special treatment is available only for cash dividends with exceptions. The new law imposes some thresholds and requires taxpayers to identify how they will reinvest the dividends in the U.S.

Expatriation

Congress is determined to crack down on U.S. citizens who relinquish their citizenship for tax avoidance purposes. The new law sets out objective rules for determining if tax avoidance motivated the move offshore.

Under the Act, a former citizen or long-term resident is subject to the alternative tax regime (section 877(b)) for the 10-year period following expatriation, unless the former citizen or long-term resident:

- Establishes that his or her average annual net income tax liability for the five preceding years did not exceed $124,000 (adjusted for inflation after 2003) and his or her net worth does not exceed $2 million, or, alternatively, satisfies limited exceptions for dual citizens and minors who have had no substantial contact with the U.S.; and

- Certifies under penalties of perjury that he or she has complied with all U.S. federal tax obligations for the five preceding years and provides such evidence of compliance as the Treasury Secretary may require[4].

[4] Note that an individual continues to be treated as a U.S. citizen or resident (as the case may be) until he or she notifies the State Department or INS and files a complete and accurate IRS Form 8854 as required by section 6039G.

Under the Act, an individual generally will resume being treated as a U.S. citizen or resident during the 10-year period in which the alternative tax would otherwise apply if the individual is physically present in the U.S. on more than 30 days during any calendar year ending in a taxable year in the 10-year period. They also will be required to file annual returns if they are subject to the alternative tax regime.. Limited exceptions to this rule apply.

These provisions apply to individuals who expatriate after June 3, 2004.

Foreign accounts

Taxpayers failing to report their foreign financial accounts risk a heightened civil penalty of $10,000. If their behavior is willful, the penalty jumps to the greater of $100,000 or 50 percent of the transaction or account.

"OTHER" REVENUE PROVISIONS

Also grouped together in the new law under the heading, "Other Revenue Provisions" are numerous ways to raise billions of dollars in revenue. Below are a few affecting the most taxpayers:

Vehicle donations

Congress voted to limit the deduction for vehicles contributed to charity. The amount of deduction will depend on how the donee organization uses the vehicle. If the charity sells the vehicle without using the vehicle in any significant way (or without improving the vehicle), the amount of the charitable deduction cannot exceed the gross proceeds from the sale.

The taxpayer also must produce an acknowledgment as to value from the charity if the charity keeps the vehicle for its own use. Stiff penalties will be imposed on charities that don't approach this obligation honestly. The charity also is required to pass along to the IRS the information in the written contemporaneous acknowledgment that it is required to give to the donor.

Intellectual property donations

Under the new rules, if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the taxpayer's initial charitable deduction is limited to the taxpayer's basis in the contributed property or its fair market value, whichever is less. The intellectual property donor is allowed to take an additional charitable deduction based on a specified percentage of the income the donee receives with respect to the donated property.

The additional deduction can be taken either in the contribution year or subsequent tax years. The amount of any additional deduction is calculated on a sliding scale. These new rules apply to contributions made after June 3, 2004.

Company aircraft

The new law closes a loophole in connection with the use of company aircraft by executives. For officers, directors, and 10-percent-or-greater owners, no deduction will be allowed for expenses for the use of a facility (such as an airplane) in connection with a nonbusiness activity, to the extent that the expenses exceed the amount treated as compensation or includible income for that individual.

Some S corporations had been passing through as deductions the full cost of the use of corporate jets by their executive/shareholders while the shareholder only had to recognize the personal use in income using the Standard Industry Fare Level (SIFL) mileage rate. That technique is now invalid.

IRS ADMINISTRATION

Installment agreements

Congress also voted to authorize the IRS to enter into partial installment agreements. The IRS must review those partial installment payment agreements at least every two years.

Consolidated return regs.

Responding to *Rite Aid,* lawmakers approved language authorizing Treasury to provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Private sector debt collection

For the first time, the IRS will be able to use private debt collection agencies to collect taxes. If the taxpayer cannot pay in full, the debt collection company can offer the taxpayer an installment agreement to pay over five years. Otherwise, it must turn the taxpayer's financial information over to the IRS for further action.

CONCLUSION:

The above are just some of the key provisions in the new Act. It is important to consult the entire Act before advising clients on current or anticipated transactions. Other provisions and changes also have been introduced or effected with regards to the following:

An above-the-line deduction for attorneys' fees and costs stemming from "unlawful discrimination" lawsuits.

Extension of the noncash contributions reporting rules.

The exclusion of certain like-kind exchange property from the homesale gain nonrecognition rules.

Reporting requirements for taxable mergers and acquisitions.

Executive Compensation and Other Employee Benefit Provisions.

About North American Tax Services

Joseph Soussan founded ***North American Tax Services*** in 1998. Since 1997, he is a member of the Certified General Accountants' Association of Ontario. He completed the CICA In-Depth Tax Course in 2000, and obtained CPA certification in 1998 from the state of Delaware. His firm is dedicated to providing both U.S. and Canadian tax expertise (as applicable to international tax situations), tax–related educational services, and technical writing assistance to Canadian accounting and law firms. Joseph speaks frequently to organizations and companies on cross-border tax matters.

He currently practices exclusively in the areas of cross-border corporate, individual, and trust and estate related taxation. He has, to date, provided extensive consulting and compliance services to the following professional accounting firms in Toronto and Montreal: Deloitte and Touche, Ernst and Young, I.T.S.G, Cross-Border Tax Services, Horwath Orenstein LLP, and other local CA firms. In addition, he has provided tax advice and services to clients of many brokerage firms in Ontario.

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