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Tax Policy

The American Jobs Creation Act of 2004

Overview of Domestic & International Provisions

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Introduction

When Republicans took control of the Congress in 1994, many in the business community hoped that reform of business taxes would soon follow. Now, a decade later, the first major broad-based restructuring of business taxes since 1986 has been accomplished with broad support from both political parties. The $137 billion in tax cuts over the next 10 years that Congress has approved in the American Jobs Creation Act of 2004 (the Act) are comprised of three major elements: tax relief for U.S.-based manufacturing activities ($77 billion), reforms in the taxation of multinational businesses ($43 billion), and approximately four dozen more targeted items of business income tax relief ($10 billion). The Act also contains several fairly targeted individual tax cuts and excise tax reforms ($7 billion).

Congress has funded these changes to business taxation with $49 billion raised from repeal of the extraterritorial income (ETI) tax provisions that the World Trade Organization (WTO) had ruled illegal and $88 billion of other tax increases. These include a broad array of anti-abuse provisions ranging from general rules assuring more transparency with respect to tax shelter activity ($3 billion) to curtailment of specific abusive transactions ($30 billion), as well as substantive changes to various individual and corporate provisions Congress regarded as loopholes $15 billion). The remainder of the revenue raising comes from extensions of IRS and Customs user fees ($19 billion), excise tax increases ($14 billion), and administrative changes ($2 billion).

This publication describes the tax cuts and tax increases contained in the Act -- the fifth significant tax bill to be sent to President Bush since he took office in 2001. If enacted by the president's signature, as expected, these provisions would shift the corporate tax burden from manufacturers and multinational companies toward companies and individuals that have historically benefited from some of the transactions no longer permitted under the legislation.

Passage of this Act, taken together with the extension of individual tax cuts and expiring provisions signed by the president on October 4, clears the tax agenda of any immediate, must-do legislative proposals. Most of the president's 2001 individual tax cuts are now fully effective through 2010, and the necessity of dealing with the WTO's concerns over the ETI regime appear close to being addressed. Annual deficits are projected to exceed $300 billion for the remainder of the decade even with the assumptions that the growth in spending will be limited to inflation and that no change is made in the individual alternative minimum tax (AMT). Both the president and his rival in the upcoming election are committed to cutting the deficit in half over the next four years. As a result, whoever occupies the White House next January will have few resources available to pay for new tax cuts and no must-pass legislative vehicles to drive additional tax cuts to the finish line.

At best, the next presidential term likely holds only tax bills in which tax cuts are fully funded with tax increases. The history of the Reagan, George H.W. Bush, and Clinton administrations raises the real prospect that deficit concerns will be addressed with a combination of tax increases and spending cuts. Thus, the prospects for easy action on tax initiatives that are not in the current legislation are not bright. The House and Senate have both passed differing versions of charitable giving and energy tax bills. The costs of these measures -- $13 billion and $16 billion respectively -- now seem more daunting to meet.

The pressure on taxes will be heightened by a number of new sunset provisions in the legislation. Together with the existing expiring provisions, these new provisions, such as an individual deduction for sales taxes and an increase in small business expensing, will bring the cost of extending expiring provisions to upwards of $14 billion annually. When Congress confronts expiring provisions at the end of 2005 or in early 2006, finding ways to pay for extending them will present a continuing challenge. Taxpayers who stand to benefit under the Act will have to be vigilant. They will need to see to it that the benefits that are phasing in are allowed to become fully effective and they will need to defend both the favorable new provisions and the transition relief that cushions the immediate impact of some of the tax increases in the legislation.

The growing reach of the AMT presents an even more dramatic challenge. The simple one-year extension of partial AMT relief signed October 4 costs $22.6 billion. Restoring the AMT to the limited reach that it had when it was enacted in 1986 would cost hundreds of billions of dollars. Many observers believe that the AMT cannot

be addressed apart from a broader discussion of what should happen when the 2001 and 2003 tax cuts expire after 2010 and apart from how the country should approach the issue of fundamental tax reform.

Readers of the descriptions that follow might fairly ask whether Congress is committed to a simpler and more economically neutral system. The multiplicity of special provisions, the creation of new distinctions between types of income, and the persistent use of long phase-in periods and temporary provisions bespeak a Congress that continues to face enormous challenges in balancing the tax needs of identifiable constituents and the generalized longing of taxpayers for a better system.

Any serious discussion of creating a better tax system must be preceded by consideration of certain key questions:

- Can the current tax system be made simpler?
- Should reform also move toward a new type of tax system that shifts the current burden within or between income classes?
- What level of government activity are we attempting to fund?

Now that they have accomplished their most pressing priorities, perhaps lawmakers in this Congress -- the majority of whom will be returning to Washington next year -- can step back and begin to address these issues in a bipartisan manner.

Source Documents Available

Click on any of the links below to view major congressional source documents related to the American Jobs Creation Act of 2004:

- **Conference Committee Report** (includes statutory language for the Act and com-pares provisions in the Act with those in the House- and Senate-passed ETI repeal bills).
- **House Ways and Means Committee Report** (includes statutory language for and des-cribes provisions in the House-passed ETI repeal bill).
- **Senate Finance Committee Report** (describes provisions in the Senate-passed ETI repeal bill).

Chapter 1:

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, and would have risen to a maximum of 17 percent in March 2005 had Congress not agreed to repeal the ETI regime.

<table>
<tr><th colspan="11">Phase-out of ETI and Phase-in of Deduction for Manufacturing Income</th></tr>
<tr><th colspan="11">ETI Repeal</th></tr>
<tr><td></td><td>2004</td><td>2005</td><td>2006</td><td>2007</td><td>2008</td><td>2009</td><td>2010</td><td>2011</td><td>2012</td><td>2013 on</td></tr>
<tr><td>ETI Benefit Allowed As Percentage of Current-Law Incentive</td><td>100</td><td>80</td><td>60</td><td colspan="7">0 (ETI fully eliminated)</td></tr>
<tr><td colspan="11">Note: Taxpayers with binding contracts in effect on September 17, 2003, and at all times thereafter are not subject to the loss of ETI benefits. The binding contract must not be between the taxpayer and a related party.</td></tr>
<tr><th colspan="11">Deduction for Manufacturing Income</th></tr>
<tr><td></td><td>2004</td><td>2005</td><td>2006</td><td>2007</td><td>2008</td><td>2009</td><td>2010</td><td>2011</td><td>2012</td><td>2013 on</td></tr>
<tr><td>Applicable Percentage Deduction for Qualified Income</td><td>0</td><td colspan="2">3</td><td colspan="3">6</td><td colspan="4">9 (Deduction fully phased in)</td></tr>
<tr><td>Effective Corporate Tax Rate at 35% Statutory Rate</td><td>35</td><td colspan="2">33.95</td><td colspan="3">32.9</td><td colspan="4">31.85</td></tr>
</table>

How the Provision Works

The Act repeals the ETI exclusion, with the following transition rules:

- For transactions before 2005, taxpayers retain 100 percent of their ETI benefits.
- For transactions after 2004, taxpayers receive 80 percent of their otherwise-applicable ETI benefits for transactions executed during 2005, and 60 percent of their otherwise-applicable ETI benefits for transactions during 2006.

Binding Contract Relief

The ETI exclusion provisions remain in effect, however, for transactions in the ordinary course of a trade or business if those transactions are pursuant to a binding contract between the taxpayer and an unrelated person. The contract must have been in effect on September 17, 2003, and at all times thereafter.

Revocation of Election to be Treated as Domestic Corporation

Under the Act, a foreign corporation that elected to be treated as a domestic corporation may revoke that election within one year from the date of enactment. Gain or loss will not be recognized on the resulting outbound reorganization on property that was (1) originally deemed to be transferred in an inbound reorganization when the election was made; or (2) acquired in the ordinary course of its business while the election was in effect and before May 1, 2003. The ETI benefit phases out completely by 2007.

Effective Date -- The proposal is effective for transactions after December 31, 2004.

Chapter 2:

Tax Relief for Manufacturers

Debate over the repeal of the extraterritorial income (ETI) tax regime has brought into sharp focus the significant role that taxes have played for manufacturers going back to the foreign sales corporation regime and the domestic international sales corporation regime before that. It also provided an opportunity to examine and address recent declines in manufacturing sector employment levels. By providing over $76 billion in manufacturing tax incentives in the Act, Congress has declared its intent to reduce the tax burden on domestic manufacturers, including small businesses engaged in manufacturing, and to promote global competitiveness.

The Act intends to provide significant tax relief for domestic manufacturers. Once it is fully phased in, eligible taxpayers will be able to deduct 9 percent of the lesser of their qualified production activities income or their taxable income for a taxable year. The deduction, however, will be limited to 50 percent of an employer's W-2 wages for a taxable year.

Eligible taxpayers may claim a 3 percent deduction in 2005 and 2006 and a 6 percent deduction from 2007 through 2009. The full 9 percent deduction is available in 2010 and thereafter. When the 9 percent deduction is fully phased in, corporations facing a marginal tax rate of 35 percent would be subject to an effective tax rate of 31.85 percent on qualifying income. Taxpayers subject to the alternative minimum tax (AMT) may take advantage of the provision, determining the amount of their deduction by reference to the lesser of qualified production activities income (as determined by regular tax) or alternative minimum taxable income without regard to the deduction.

Observation

The Act is not "contingent on export performance," and therefore conforms to World Trade Organization guidelines. However, the reduction in tax rates for businesses that produce items that can be exported could partly or entirely replace the lost ETI tax benefit.

Eligible Taxpayers

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 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.

Observation

One sobering note before we encourage all manufacturers to break out the champagne: 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.

Eligible Income

Qualified production activities income eligible for the deduction is equal to domestic production gross receipts reduced by the sum of:

- The costs of goods sold that are allocable to such receipts;
- Other deductions, expenses, or losses that are directly allocable to such receipts; and
- A share of other deductions, expenses, and losses not directly allocable to such receipts or another class of income.

Domestic production gross receipts are gross receipts of a taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of:

- Qualifying production property that was manufactured, produced, grown, or extracted in

whole or in significant part by the taxpayer in the United States;

- Qualified film produced by the taxpayer; or
- Electricity, natural gas, or potable water produced by the taxpayer in the United States.

Domestic production gross receipts also include receipts of a taxpayer from construction, engineering, or architectural services performed in the United States for construction projects in the United States.

Observation

Construction projects including erection or substantial renovation (structural improvements) would qualify as production activity. Cosmetic changes such as painting would not qualify.

Significantly, domestic production gross receipts do not include any gross receipts from the following activities:

- The sale of food or beverages prepared by the taxpayer at a retail establishment; or
- The transmission or distribution of electricity, natural gas, or potable water.

Observation

The gross receipts of a taxpayer who owns a facility that produces electricity, gas, or potable water would qualify for the deduction while a taxpayer who transmits or uses a distribution system to sell electricity, gas, or potable water to customers would not qualify. To the extent that the taxpayer is an integrated producer that generates and delivers electricity, gas, or potable water to customers, any gross receipts attributable to production would qualify while gross receipts allocated to transmission or distribution would not.

Finally, domestic production gross receipts eligible for deduction may not stem from property that is leased, licensed, or rented by the taxpayer for ultimate use by any related person.

Effective Date -- This provision is effective for taxable years beginning after December 31, 2004.

Qualifying Production Property and Film Property

Qualifying production property generally is any tangible personal property and computer software, as well as sound recordings.

Qualifying film property is any film and videotape, except for certain sexually explicit productions, if 50 percent or more of the total compensation relating to the production of the property was paid for services performed in the United States by actors, production personnel, directors, and producers.

Finally, the provision permits taxpayers to revoke -- without IRS consent -- an election, made for a taxable year ending on or before the date of enactment, to treat the cutting of timber as a sale or exchange.

Effective Date -- This provision is effective for taxable years beginning after December 31, 2004.

Observation

Gray Area for Tax Planning Purposes -- The concept of manufacturing income is virtually certain to create a new source of consternation and regulatory complexity. No concept in existing law captures it exactly. As issues arise, they will need to be studied and addressed. The outcome is likely to involve a significant body of rules and interpretations that settle some arguments, and create others. For instance, how much value must be added to an item before it is "manufactured . . . in significant part" by a taxpayer? Would "kit assembly" qualify? How about installation of optional equipment prior to sale? What about a distributor that engages in substantial packaging activities? Taxpayers and the Treasury will have to grapple with these and other issues.

The identification of eligible receipts will pose a number of challenges for different taxpayers. For example, where the provision of services is a material element of the taxpayer's delivery of goods to customers, this will presumably have to be carved out of eligible receipts, with corresponding adjustments to deductible costs. The ability of existing financial statement information systems to handle these sorts of challenges is almost certain to be sorely tested. With the deduction set to go into effect beginning in 2005, it will be impossible for

most taxpayers to make the appropriate system modifications in time.

The identification of costs and deductions associated with production activities will likewise prove challenging. Congressional reports suggest that Treasury look to the existing guidance under the uniform capitalization rules (section 263A) and the sourcing rules for foreign and domestic income and expense (sections 861 and 862). Although taxpayers may take comfort from precedents established in these areas, it likely will take years -- and numerous pages of regulations -- before the dust settles. Significant tension may exist between current views of these rules and their use in the context of a manufacturing deduction. Today, all other things being equal, the government would want to view an expense as foreign-source (to minimize sheltering of U.S. income). Looking solely at the production activity deduction, the government might want to argue the issue differently than it has in the past.

Also consider that it may be necessary to undertake transfer pricing analyses to determine the appropriate allocation and apportionment of costs. In fact, Congress intends that Treasury provide guidance, drawing on the principles of section 482, by which taxpayers can allocate gross receipts between qualified and nonqualified gross receipts.

Be prepared for a number of unexpected consequences, as well. Consider the captive leasing subsidiary of a manufacturer. Such activities have traditionally provided a desirable tax deferral for many manufacturers. Now, they may result in a penalty by reducing or eliminating the deduction otherwise available from sales of products.

New Tax Planning Opportunities -- On the other hand, planning opportunities will likely multiply. For the same manufacturer with a captive leasing operation, the built-in tax gain typically associated with property eligible for accelerated depreciation would be a potential source of significant eligible income. Likewise, the decision to elect accelerated or straight-line depreciation (on both production and leased assets) would involve additional consideration of the impact on overall eligible manufacturing income.

Chapter 3:

Executive Compensation and Other Employee Benefit Provisions

Overview

The Act contains provisions that will significantly change the tax treatment of deferred compensation. These provisions have their roots in concerns raised by the collapses of companies like Enron and World-Com, increased scrutiny of generous pay packages for corporate executives, and negative publicity over tax-driven deferred compensation plans at public companies. The Act also includes provisions related to reporting and withholding and certain expense deductions.

In simplest terms, the Act:

- Adopts a very broad definition of nonqualified deferred compensation.
- Restricts the flexibility executives have had in controlling distributions.
- Effectively shuts down the use of offshore rabbi trusts and certain trusts that become protected from creditors (or distribute assets to executives) on a change in the employer's financial condition.
- Penalizes the failure to comply with the deferral or funding restrictions with immediate taxation of the deferred amounts.
- Imposes a 20 percent tax and interest at the underpayment rate plus 1 percentage point on participants affected by a plan failure.
- Is effective for amounts earned, vested, and deferred after December 31, 2004. However, a material modification of a plan or agreement after October 3, 2004, will cause those plans' pre-2005 deferrals to be treated as post-December 31, 2004 deferrals.

New Rules for Nonqualified Deferred Compensation Plans

Overall, the Act significantly restricts nonqualified deferred compensation plans. It also treats offshore rabbi trusts and trusts with financial health triggers as fully funded plans.

Under the Act, amounts deferred under a nonqualified deferred compensation plan are includible in income at the time of deferral or, if later, when no longer subject to a substantial risk of forfeiture, unless the nonqualified deferred compensation plan complies with requirements related to elections, distributions, and acceleration provisions. The plan document itself must comply with these requirements and the plan must be operated consistently.

Observation

The changes in the tax treatment of nonqualified deferred compensation under the Act will necessitate review of current arrangements and planning for the future to ensure that the objectives of the compensation arrangements continue to be met. This review is all the more important given the current executive compensation audit initiative by the IRS and the likelihood that the accounting treatment for equity-based plans may well change over the next few years.

What is a 'Nonqualified Deferred Compensation Plan'?

The definition of "nonqualified deferred compensation plan" under the Act is very broad. With limited exceptions, any plan that provides for deferral of compensation is subject to these provisions (unless excluded by Treasury regulations to be issued in the future). Qualified retirement plans, qualified tax-deferred annuities, and section 457(b) plans, including those sponsored by tax-exempt employers, are not subject to the Act. Bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans are also not subject to the Act.

Far more arrangements, however, are subject to these new provisions. Nonqualified deferred compensation plans can be elective or nonelective, stand-alone plans or plans associated with qualified retirement plans, and plans whose value increases with employer stock appreciation. Equity compensation arrangements that traditionally may not have been thought of as providing

deferred compensation are covered.

Examples of arrangements that are commonly used by employers and fall under the definition of nonqualified deferred compensation plans subject to the Act are:

- Account-based plans that allow an employee to elect to defer salary or bonus;
- Supplemental Executive Retirement Plans (SERPs), that provide additional benefits based on the qualified retirement plan formula;
- Restricted stock units or phantom stock unit plans (that is, deferred compensation designated in employer stock);
- Stock options, other than options on employer stock with an exercise price that is not less than the fair market value of the stock on the date of grant;
- Stock appreciation rights (SARs); and
- Bonus plans under which payment is made after the bonus is earned.

In addition, a "plan" can be a plan covering more than one person or any other arrangement or individual agreement that provides for deferral of compensation. Nonqualified deferred compensation plans can cover hundreds of people or be a single provision in one individual's employment agreement.

Observation

As discussed in more detail below, a limited number of these arrangements may already comply with the new provisions. Most arrangements, however, will need significant revision or, as a practical matter, cannot continue with beneficial tax treatment after the effective date of the Act. It is important to consider the ramifications of the Act on a wide range of compensation plans.

In particular, SARs are covered by the Act. As a practical matter, the basic structure of an SAR will have to be fundamentally altered for it to comply with the distribution and acceleration restrictions. Companies that have been considering stock-settled SARs as a response to possible changes in option accounting treatment will need to revisit this approach in light of the adverse tax consequences for current SAR designs.

Elections

In general, the Act requires that an election to defer must be made by the end of the taxable year preceding the year in which services will be performed. Newly eligible employees are permitted to make deferral elections within 30 days after becoming eligible.

A significant exception to this general rule applies to performance-based compensation for services over a period of at least 12 months. In this case, the deferral election must be in place six months before the end of the service period (and otherwise comply with the constructive receipt principles). Treasury is also expected to issue guidance to address the timing of elections for plans with fiscal year performance.

Observation

These requirements on initial elections follow the IRS ruling position, but case law supports later elections in some circumstances. General practice has been more aggressive than the IRS ruling position, and, for this reason, many arrangements will need to be reviewed prior to any future election.

The exception for performance-based plans with at least a 12-month service period is important for companies that allow employees to defer bonuses earned annually, or over a multi-year performance period. For example, an employer's three-year long term incentive plan running from January 1, 2005, to December 31, 2007, may need to conform to the new rules even though the bonus is not payable until March 2008. With this exception, elections may be allowed as late as June 2007 -- six months before the performance period ends in December 2007.

The plan or election must include the timing and form of distribution, and these must comply with the new provisions. If the plan gives participants a choice of when to receive a distribution, that choice must be made based on the elective deferral rules. The legislative history specifically notes that it is permissible for deferrals during a year to have different distribution elections -- such as 25 percent in a lump sum in five years, 75 percent as an annuity at retirement. Deferrals for different years can have different distribution schedules. This may be relatively more difficult for a plan administrator, but it is likely to be a popular approach to providing some measure of flexibility, especially when

combined with the restrictions on redeferrals.

The Act does allow redeferrals of compensation. A redeferral election would have to be made not less than 12 months before a scheduled payment, not take effect until at least 12 months after the election, and provide for a deferral of at least five years. This five-year redeferral period can be overridden only by distributions for death, disability, or unforeseeable emergency.

If a redeferral election is made, then a distribution cannot be made on separation from service or upon a change of control during the redeferral period. Treasury can issue guidance permitting elections to change a stream of payments in limited cases.

Observation

For nonelective plans, such as SERPs, the requirement that the timing of distributions be set at initial deferral, combined with the restrictions on redeferrals, is likely to require plan distribution provisions to be redesigned. For example, in many cases, SERPs will allow participants to elect the form and timing of a distribution after the deferral is credited under the plan, such as when the participant is approaching retirement.

Limited Access to Distributions

The Act restricts the flexibility executives have had in controlling distributions, particularly in accelerating distributions.

Under the Act, employees may receive distributions from nonqualified deferred compensation plans only upon death, separation from service, disability, at specified times (or pursuant to a fixed schedule), following a change in ownership or control of the corporation, or on the occurrence of an unforeseeable emergency. In applying these changes, the Act requires that:

- A “key employee” of a corporation whose stock is publicly traded on an established securities market must wait for at least six months after departure to receive a distribution upon separation from service. Generally, for this purpose, a key employee is: (1) an officer with greater than $130,000 in compensation, (2) a 5 percent owner, or (3) a 1 percent owner with greater than $150,000 in compensation.
- A distribution is allowed at a “specific time” or pursuant to a fixed schedule only if the time or schedule is specified at the time the income is deferred.
- Distributions made upon a change of control may only be made under circumstances designated by Treasury. Congress has instructed Treasury to use a similar but more restrictive definition of change of control than is used in the golden parachute rules, and to issue guidance within 90 days after enactment.
- An unforeseeable emergency is limited to severe financial hardships, including those resulting from illness or an accident of the participant or beneficiary (or other qualifying individuals), and property loss due to casualty. The amount of the distribution must be limited to the amount necessary to satisfy the emergency (taking into account any insurance proceeds or other reimbursements and the sale of other assets that can be liquidated without severe financial hardship) plus taxes reasonably anticipated as a result of the distribution.
- A participant generally is considered to be disabled if: (1) the participant is unable to be gainfully employed as a result of a mental or physical impairment that is expected to last at least 12 months, or (2) the participant is receiving benefits for at least three months in accordance with the terms of an employer’s disability plan by reason of a mental or physical impairment that is expected to last at least 12 months.

Prohibition on Acceleration of Distributions

The legislation also prohibits any acceleration of a distribution, except as provided in regulations. Treasury is expected to provide limited exceptions, such as when acceleration is required for reasons beyond the participant’s control and the distribution is not elective. Treasury can also provide rules allowing for a choice between actuarially equivalent life annuity payments. The choice of cash or property for a specific distribution will not be an acceleration of a distribution.

This change related to limiting access to distributions is perhaps the most dramatic, as it would eliminate the ability to use a forfeiture clause as a substantial limitation on the receipt of deferred compensation. For example, a so-called “haircut” provision -- one allowing the participant to receive distributions upon request, subject to the forfeiture of a set percentage (commonly 10 percent) -- would no longer be permissible. These provisions have been widely used in recent years and are found in many plans.

Observation

In addition to haircut provisions, many nonqualified deferred compensation plans provide other types of acceleration clauses that may be less obvious, but are nevertheless precluded by the new legislation.

For example, because the Act applies to all SARs and options, except for options granted on employer stock with an exercise price that cannot be less than fair market value at grant (an at-the-money employer stock option), many common executive compensation techniques will no longer be available. Under pre-Act law, SARs did not result in constructive receipt because exercise required the forfeiture of the valuable right to future appreciation. The ability to exercise an SAR or option is an acceleration clause, just like a 10 percent haircut. To impose an acceleration restriction on an SAR would effectively eliminate one of the major advantages of an SAR over a restricted stock unit or phantom stock plan.

Many employers grant employees options on property other than employer stock or discounted options. There is no statutory provision exempting property transfers from the new deferred compensation rules. The legislative history notes a limited exception for options on employer stock granted with an exercise price of at least the fair market value of the property on the date of grant. As with SARs, imposing the restrictions that would comply with the Act is, as a practical matter, inherently inconsistent with the underlying design of options.

Similarly, SERPs and other nonelective plans often allow participants to elect lump sums, installment distributions (over a period of 5 or 10 years, or longer), or annuity forms of payment. The timing of distributions will need to be set by the participant's election at deferral or in the plan. These plans also will need to restrict changes to comply with the redeferral requirements.

Often in a merger or acquisition, options on the stock of the target company are converted into options on stock of the acquirer. Although these options were granted with an exercise price based on fair market value at grant, they will often have a "discount" if measured at the time of the acquisition. It is expected that this type of conversion will not be considered a new grant of a discounted option and thus will not result in immediate taxation. We can expect, however, that Treasury may issue guidance restricting this carveout to conversions done in a specified manner.

Funding Nonqualified Deferred Compensation: Offshore and 'Financial Health' Trusts

Under the Act, two means of providing assets for a nonqualified deferred compensation arrangement will result in current income: offshore rabbi trusts and trusts that become protected from creditors (or distribute assets to participants) on a change in the employer's financial health.

The Act does, however, include a specific exception for offshore trusts if substantially all the services to which the deferred compensation relates were performed in the jurisdiction where the assets are located. In addition, it provides authority to remove some offshore trusts from the restrictions if there is no improper deferral of U.S. tax and the assets are not effectively beyond the reach of creditors. Trusts that fail to comply with these restrictions would be subject to tax applicable to funded plans (so-called "secular trusts"), even if the trust documents provide that assets are available to creditors.

Observation

Many employers fund nonqualified deferred compensation for offshore employees in a trust that is not located in the country in which services are being rendered. To the extent these plans include individuals subject to U.S. income tax, the funding may need to be modified to protect the tax benefits of the plans.

While the Act applies only to offshore trusts, there is authority for regulations to exempt arrangements from these same rules if the arrangements do not improperly defer U.S. tax and will not result in assets beyond the reach of creditors. Congress has specifically focused on arrangements in which the foreign trust effectively shields assets from the claims of general creditors. The provision clearly reflects the belief that these plans should be treated as funded plans and result in current income.

Penalties

Failure to comply with either the deferral or funding restrictions would result in current taxation of the amounts deferred. The Act also provides for an additional 20 percent tax and annual interest at the underpayment rate plus 1 percentage point beginning with the first taxable year in which amounts were first deferred, or when the deferral became substantially vested, if later. For provisions related to trusts, the tax applies for each year that the assets are held in trust or subject to the financial health trigger, with interest accruing from the first year of deferral -- a period that could be longer than the period during which the assets are held in trust or subject to the financial health triggers.

The penalties apply only to those participants affected by the plan failure. For example, if an employer maintains several plans, only one of which includes a distribution option that violates the requirements of the Act, only the participants in that plan are subject to income inclusion and the 20 percent penalty. Similarly, if only one plan participant's deferral election does not properly conform to the required distribution rules, only that participant's deferrals would be currently taxed.

The Act does not otherwise change the rules applicable to employer deductions.

Observation

In designing new plans and deferral arrangements, employers will need to consider a provision that allows for immediate payment in the event amounts are found to be currently taxable as a result of this rule. Whether such a provision is a permissible distribution is an open question that may require more guidance.

Effective Date -- These changes with respect to access and funding are effective for amounts deferred in taxable years beginning after December 31, 2004. Treasury has been directed to provide a limited period during which elections for amounts deferred after December 31, 2004 could be revoked or made to conform to the new rules.

Amounts deferred before 2005, and earnings on those amounts, generally would not be subject to the new requirements. However, a material modification of a plan or agreement after October 3, 2004, will cause those plans' deferrals to be treated as post-December 31, 2004 deferrals.

Observation

The full details of the grandfather provisions will need to be developed through guidance.

Many employers are providing deferral elections right now with respect to 2005 salary or bonuses to be earned or paid in 2005. The new rules will apply to any amount that is not earned and vested on or before December 31, 2004. Thus, if an individual is eligible for a 2004 bonus on the condition that he or she is still employed in 2005, the bonus can be deferred only under the new rules.

Modifying the provisions of any plan, arrangement, employment contract, or deferral election to accelerate vesting will not avoid the new rules. Such a modification will make all deferrals under that plan subject to the new rules. Similarly, excessive grants of SARs or discounted options and unusually large accruals of deferred compensation will likely be determined to be subject to the new rules.

Amounts earned, vested and deferred prior to 2005 will continue to be subject to pre-Act law, along with any earnings on these amounts. These amounts will remain subject to pre-Act law even if redeferred, if the plan is not materially modified. For account-based plans, preserving the grandfather will require setting up two accounts and monitoring any modifications to pre-2005 deferrals to prevent inadvertently subjecting those deferrals to the Act. For nonaccount-based plans, an offset arrangement should be considered.

Withholding and Reporting

Forms W-2 and 1099 Reporting

The Act provides that amounts deferred -- whether or not included in the employee's wages -- have to be reflected on the employee's Form W-2. A similar rule requires reporting on Form 1099 of amounts deferred with respect to an independent contractor. The Treasury Department is permitted to establish de minimis thresholds for reporting. The conference report for the Act indicates that it is also expected that Treasury will issue guidance on reporting amounts under a nonaccount plan based on when they become reasonably ascertainable (determined in a manner similar to that applicable to the FICA tax treatment of nonaccount-based nonqualified deferred compensation plans).

Effective Date -- These reporting requirements apply to nonqualified deferred compensation otherwise subject to the Act: deferrals after December 31, 2004, and deferrals for prior periods treated as post-2004 deferrals because of material modifications.

Increased Withholding for Supplemental Wage Payments

Under the Act, employee supplemental wage payments over $1 million will be subject to withholding at the top marginal rate (35 percent for 2005). Currently, a flat withholding rate of 25 percent generally is applied to these payments. For purposes of determining the $1 million amount, supplemental wage payments to an employee from all members of a controlled group of entities are to be aggregated.

Observation

This change in law has no overall effect on the total amount of tax an individual pays in a given year. It merely changes the timing of the payment -- accelerating the taxes paid -- and perhaps decreases the amount of estimated tax payments required to be made.

The aggregation rule may require significant modifications to payroll systems of companies whose employees receive supplemental wage payments from more than one entity in the controlled group, since this information typically is not aggregated. Prior to this rule, aggregation was not needed.

Effective Date -- The provision is effective for payments made after December 31, 2004.

Exclusion of Incentive Stock Options and Employee Stock Purchase Plan Stock Options From Wages

The Act codifies an existing IRS moratorium on the assessment of payroll taxes on income resulting from the exercise of incentive stock options or transfers of stock under an employee stock purchase plan, or any dispositions of such stock. The Act also states that employers are not required to withhold federal tax from a disqualifying disposition and any compensation related to a discount allowed under an employee stock purchase plan.

Effective Date -- The provision is effective for stock acquired under options exercised after the date of enactment.

Employer Deductions

Personal Use of Company-Owned Airplanes; Entertainment Expenses for Corporate Executives

Several years ago, the courts agreed with taxpayers and allowed a company to deduct expenses for employees and other service providers associated with personal flights on corporate-owned aircraft in excess of the income included in the compensation of the executives.

Under the Act, corporate deductions attributable to the personal use of certain goods, services, or facilities are prohibited to the extent expenses exceed the income included in the compensation of the individual incurring the use. The provision, intended to overturn Sutherland Lumber-Southwest Inc. v. Commissioner, 114 T.C. 197 (2000), aff'd 255 F.3d 495 (8th Cir. 2001), acq. AOD 2002-02 (Feb. 11, 2002), applies to individuals subject to section 16(a) of the Securities Exchange Act of 1934, or those who would be subject to these requirements if the employer or service recipient were an issuer of such equity securities.

Effective Date -- The limitation is effective for expenses incurred after the date of enactment.

Provisions Related to Global Employers

Distributions From Foreign Pension Plans

Under current law, certain employer contributions made to foreign pension plans may create investment in the contract (also known as basis) even though the plan participant did not pay tax on contributions. Generally, this treatment applies only to resident aliens of the United States. The creation of basis results in tax-free payments from the plan.

Under the Act, distributions on or after the date of enactment are fully taxed, except to the extent of contributions or earnings previously taxed by the United States or any foreign government. This means the opportunity to increase a participant's basis in a foreign pension plan to include nontaxable employer contributions will no longer exist. In addition, similar rules will apply for compensatory property transfers.

Effective Date -- The provision is effective for distributions on or after the date of enactment.

Observation

Consideration should be given to whether an early distribution from a foreign pension plan before the legislation's effective date would be appropriate. Various factors should be weighed when assessing the benefit of taking an early distribution from a foreign pension plan, including, but not limited to, the following:

- An individual's ability to protect income earned by the foreign pension plan from taxation;
- An individual's investment strategy regarding the early distribution;
- The taxable earnings of the foreign pension plan included in the distribution that would have to be recognized;
- Potential penalties for early withdrawal; and
- The age of the individual.

For example, the individual's ability to prevent income earned under the foreign pension plan from taxation may outweigh the increased basis benefit from an early distribution. Consideration should be given to how the individual intends to use the distributed funds (for investments, personal expenditures, etc.) and, if the funds are to be reinvested, the potential returns on the various investment options. Older individuals who are close to retirement may benefit more from early distributions than younger individuals. Younger individuals enjoy the ability to compound earnings on pension assets tax-free for a longer period of time.

These are only a few of the issues that should be considered when assessing the overall benefit of an early distribution from a foreign pension plan. A determination must be made on a case-by-case basis.

Qualified Plans and Health Coverage

Minimum Cost Requirements for Transfers of Pension Plan Assets

The Act provides that an employer will not fail the minimum cost requirement for retiree health costs if, in lieu of a reduction of health coverage permitted by Treasury regulations, the employer reduces the applicable employer cost by an amount that does not exceed the cost that would have occurred if the employer had made the maximum permissible reduction in retiree health coverage. Only employers that have current retiree health liabilities that were at least 5 percent of the employer's gross receipts during the preceding taxable year can take advantage of this rule.

Effective Date -- The provision is effective for taxable years ending after the date of enactment.

Chapter 4:

International Tax Reforms

The Act contains a number of international provisions that, if enacted, will require tax executives to determine the short-term and long-term impact on their worldwide effective tax rate. The provisions of the bill would require companies to determine the net benefit or detriment attributable to the replacement of the extraterritorial income (ETI) exclusion with the proposed deduction for income from domestic production activities (See Chapter 2).

In addition, multinational companies with significant operations in low-taxed subsidiaries must evaluate the amount of earnings they will repatriate from controlled foreign corporations (CFCs) in order to take advantage of the temporary 85 percent dividends received deduction for cash dividends in excess of a historical "base-period average." This analysis will likely require consideration of the ability to distribute cash, the foreign tax credit impact of the distributions, and the foreign tax cost of repatriation. Tax departments will be charged with determining the tax and treasury ramifications of this legislation, requiring information related to cash flow, debt capacity, and the earnings and profits and creditable taxes of foreign subsidiaries.

Incentive to Reinvest Foreign Earnings in the United States

The Act allows a U.S. corporation to elect to deduct 85 percent of certain "cash dividends" it receives from its controlled foreign corporations (CFCs), either during the taxpayer's last tax year which begins before the date of enactment, or during its first tax year which begins during the one-year period beginning on such date.

The term "cash dividend" generally includes cash amounts included in gross income as dividends, such as cash amounts treated as dividends under sections 302 or 304. A cash dividend also includes a cash distribution received from a CFC during the election year that is excluded from gross income as previously taxed income (PTI), to the extent of subpart F inclusions as a result of an election-year cash dividend received by that CFC from another CFC, or received by another CFC (to the extent of cash distributions of PTI to the first CFC from which the U.S. shareholder received its cash distribution). However, the term does not include section 956 inclusions, or amounts includible in gross income as a dividend under sections 78 or 1248 (or, in some cases, 367).

Additionally, the dividend must meet a number of criteria to be deductible:

- If the dividend is paid from funds borrowed from a related person (other than another CFC), such as the U.S. shareholder, the net increase in CFC indebtedness to such lenders reduces the deductible amount of the dividend.
- The dividend must exceed a historical base-period average of dividend (cash or noncash) and other repatriation amounts. A CFC cash dividend received by the shareholder during the election year is eligible for the deduction only to the extent it exceeds an average of the annual sums of dividends, section 956 inclusions, and certain PTI distributions received during the base period. The base period generally is comprised of the five taxable years ending on or before June 30, 2003, discarding the years with the highest and lowest annual amounts.
- An amount equal to the dividend must be invested in the U.S. pursuant to a domestic reinvestment plan approved by the taxpayer's top officer before the dividend is paid, and subsequently approved by the board of directors or similar body. The domestic reinvestment plan must provide for the reinvestment of the dividend in the U.S. (other than as payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments or the financial stabilization of the corporation for the purposes of job retention or creation. This list of permitted uses is not exclusive.
- Eligible dividends generally cannot exceed $500 million unless a greater specific amount of earnings is described as permanently reinvested outside the U.S in the corporation's most recent audited financial statement filed with the SEC on or before June 30, 2003 (or, if SEC filing is not required, certified on or before that date as prepared in accordance with GAAP and used as a statement or report to creditors, to shareholders,

or for any other substantial non-tax purpose). If the applicable financial statement does not specify the amount of earnings permanently reinvested outside the U.S. but does specify a tax liability attributable to such earnings, the amount eligible for the DRD is the amount of the tax liability divided by 35 percent.

Specific rules adjust the allowance of credits and deductions and the computation of the alternative minimum tax. Fifteen percent of the dividends to which the deduction is applied represents a floor below which the taxpayer's taxable income cannot fall.

Effective Date -- The provision applies to tax years ending on or after the date of enactment. The taxpayer may elect the deduction for its last taxable year which begins before the date of enactment, or its first taxable year which begins during the one-year period beginning on such date (and the election must be made for a taxable year before the due date (including extensions) for filing the return for that year).

Foreign Tax Credit Reforms

Reduction in Number of Foreign Tax Credit Baskets

The Act reduces the number of baskets from nine to two for taxable years beginning after December 31, 2006. The two baskets are:

- Passive category income; and
- General category income.

Passive category income includes passive income, as currently defined, as well as dividends from a DISC, distributions from a FSC and foreign trade income.

Financial services income, as currently defined by the Code, constitutes general category income if earned by a member of a financial services group (an affiliated group, expanded to include life insurance companies and foreign corporations) or any other person that is predominantly engaged in the active conduct of a banking, insurance, financing or similar business.

The Act grants regulatory authority to address income received or accrued by partnerships and other pass-through entities.

Effective Date -- The amendments are effective for taxable years beginning after December 31, 2006. Under a transitional rule, taxes carried from any tax year beginning before January 1, 2007 to any tax year beginning on or after such date, are allocated to one of the two baskets as if the new rules were in effect on the date the taxes were paid or accrued. In the case of taxes carried back from a post-2006 year, regulatory authority is provided to basket such taxes according to the limitation regime in effect in the carry-to year.

Foreign Tax Credit Treatment of "Base Difference" Items

While current regulations that require that foreign tax imposed on an amount that is not considered an item of income under U.S. principles be allocated to the general limitation category for purposes of the foreign tax credit limitation (and the Act codifies that rule for taxable years in which the baskets are reduced to two, as described above), the Act also affords taxpayers an election for the years beginning after December 31, 2004, and before January 1, 2007, to allocate taxes associated with such foreign "base differences" to the financial services income category. This election may not be revoked without the Commissioner's consent.

Effective Date -- The election applies to taxable years beginning after December 31, 2004, while the codification of the regulatory "base differences" rule applies to taxable years beginning after December 31, 2006.

Foreign Tax Credit Carryover Periods

The Act provides a one-year carryback and 10-year carryforward for unutilized foreign tax credits paid or accrued in a given year, including oil and gas extraction taxes.

Effective Dates -- With respect to foreign tax credit carrybacks, the Act applies to excess foreign tax credits arising in taxable years beginning after the date of enactment. For carryforwards, the Act applies to excess foreign tax credits that may be carried to any taxable year ending after the date of enactment.

Interest Expense Allocation Rules

The Act provides a one-time election to change the method under which the interest expense of U.S. group members is allocated and apportioned between U.S.-source and foreign-source. An additional election for financial institutions is also included in the Act.

Currently, corporate taxpayers allocate and apportion interest expense between U.S.-source and foreign-source income by determining the ratio of gross foreign assets to domestic assets owned by the taxpayer and affiliated domestic corporations. For purposes of determining this ratio, all of the assets of the domestic affiliated group are treated as assets of a single corporation.

However, with respect to foreign subsidiaries, the stock of the subsidiaries is taken into account rather than the assets of those subsidiaries. The Act permits taxpayers to look to the assets and interest expense of certain foreign corporations when determining whether the interest expense of the domestic taxpayers must be allocated to foreign-source income.

For electing taxpayers, unrelated party interest expense is allocated and apportioned to foreign-source income in an amount equal to the excess (if any) of: (1) the third-party interest expense of the "worldwide affiliated group" multiplied by foreign asset ratio of the worldwide affiliated group; over (2) the third-party interest expense incurred by foreign members of the group that would have been allocated and apportioned to foreign-source income if the foreign members constituted their own group.

The Act permits taxpayers to continue applying current rules that exclude certain financial institutions from the affiliated group for interest allocation and apportionment purposes under the worldwide fungibility method. The Act also contains a provision allowing for a one-time election to expand the definition of a bank group for purposes of interest expense allocation and apportionment.

Effective Date -- These provisions apply for taxable years beginning after December 31, 2008.

Recharacterize Overall Domestic Loss

The Act permits taxpayers to undo the harmful effect of domestic losses on their foreign tax credit limitation, allowing a "recapture" that is somewhat symmetrical to the treatment of overall foreign losses. A portion of the taxpayer's U.S.-source income for each year following an overall domestic loss is recharacterized as foreign-source income in an amount equal to the lesser of: (1) the amount of the unrecharacterized overall domestic losses for years prior to such succeeding taxable year, or (2) 50 percent of the taxpayer's U.S.-source income for such succeeding taxable year.

Effective Date -- The provisions apply to overall domestic losses sustained in a taxable year beginning after December 31, 2006. The effective date appears to permit a taxpayer that incurs an overall domestic loss in a tax year after 2006 to obtain favorable treatment even if the loss is carried back to reduce foreign-source income in a pre-2007 year.

Look-Through Rules to Apply to Dividends From Noncontrolled Section 902 Companies

The Act applies look-through treatment to all earnings of a 10/50 company, regardless of when accumulated. Thus, all dividends from 10/50 companies are generally allocated to separate categories of income in proportion to earnings of the subsidiary that paid the dividend. However, if a dividend's look-through treatment has not been adequately substantiated, such dividend is treated as passive income.

Effective Date -- The provisions are effective for tax years beginning after December 31, 2002. Look-through treatment is specifically provided for foreign tax credit carryforwards from pre-2003 years to the extent a carryforward is attributable to 10/50 dividends. Regulatory authority is granted to address foreign tax credit carrybacks to pre-2003 years to take into account the separate categories of income in effect in the taxable year to which the taxes are carried.

Repeal of Limitation of Foreign Tax Credits Under Alternative Minimum Tax

The Act repeals the limitation that provides that foreign tax credits may only offset 90 percent of a taxpayer's alternative minimum tax liability.

Effective Date -- The provision applies for taxable years beginning after December 31, 2004.

Clarification of Treatment of Certain Transfers of Intangible Property

The Act treats amounts deemed to be received, in connection with certain outbound transfers of intangible property, as royalties for purposes of determining the particular foreign tax credit limitation that applies to the income from those amounts.

Effective Date -- The provisions are applicable to amounts treated as received on or after August 5, 1997 (the effective date of the change-in-source rule for such payments in the 1997 Act).

Election Not to Use Average Exchange Rate for Foreign Tax Paid Other Than in Functional Currency

The Act provides an election to translate nonfunctional currency taxes into U.S. dollar amounts using the exchange rate for the day of payment rather than an average exchange rate for the taxable year. The election applies to the taxable year for which the election is made and to all subsequent years unless revoked with the consent of the Secretary.

Effective Date -- The provisions are effective for tax years beginning after December 31, 2004.

Attribution of Stock Ownership Through Partnerships

The Act provides that, for purposes of claiming indirect foreign tax credits, stock owned by a partnership is considered owned proportionately by its partners. This makes clear that indirect credits will flow through a partnership (either foreign or domestic). The Act also modifies the existing rule that allows "individual" partners or beneficiaries a credit for foreign taxes paid by a pass-through entity by substituting "person" for "individual" in the statute, thus clarifying that corporate partners also are allowed direct foreign tax credits for their share of taxes paid by a partnership.

Effective Date -- The provisions are effective for taxes of foreign corporations for taxable years beginning after the date of enactment.

Subpart F Reform

Under present law, "subpart F income" of a CFC is currently included in the income of the CFC's U.S. shareholders, and a CFC's ownership of "U.S. property" can have an effect on the CFC's U.S. shareholders similar to that of receiving a dividend from the CFC. The legislation eliminates certain types of income from the definition of "subpart F income" and modifies the definition of "U.S. property."

Modifications to Treatment of Aircraft Leasing and Shipping Income

The Act eliminates income from or in connection with the use (or hiring or leasing use) of a vessel or aircraft in foreign commerce, or in connection with the performance of directly related services, from the definition of subpart F income.

The Act adds a safe harbor that allows rents from leasing aircraft or vessels for use in foreign commerce to be excluded from subpart F income if active leasing expenses are not less than 10 percent of the profit on the lease.

Effective Date -- These provisions apply to taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of U.S. shareholders owning stock in such corporations with or within which such taxable years of those corporations end.

Look-Through Treatment for Sales of Partnership Interests

The Act provides an exception from the general rule that all gain from the sale of a partnership interest is subpart F income. The Act treats the sale by a CFC of a partnership interest as a sale of the proportionate share of the partnership assets attributable to such interest if the CFC is a direct owner of 25 percent or more of the capital or profits interest in the partnership. For this purpose, a CFC is treated as owning directly its proportionate share of a capital or profits interest owned by a corporation or partnership in which the CFC has an interest.

Effective Date -- This provision applies to dispositions in taxable years of foreign corporations beginning after December 31, 2004, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Determination of Foreign Personal Holding Company Income for Transactions in Commodities

The Act modifies the requirements for gains or losses from a hedging transaction in commodities to be excluded from the category of subpart F income known as "foreign personal holding company income" (FPHCI). Under the Act, any transaction with respect to a commodity entered into by a CFC, in the normal course of the CFC's trade or business to manage the risk of price changes or currency fluctuations with respect to ordinary property or depreciable property used in the trade or business, will qualify as a hedging transaction that can be excluded from FPHCI, provided the transaction is identified as a hedging transaction at the time the hedge is entered into.

The Act also changes the requirements that must be satisfied for active business gains or losses arising from the sale of commodities to qualify for exclusion from FPHCI. Active business gains or losses from the sale of commodities will not constitute FPHCI provided substantially all of the CFC's commodities consist of the following: (1) stock in trade, inventory or property held primarily for sale to customers in the ordinary course of trade or business; (2) depreciable trade or business property; or (3) supplies of a type used or consumed in the ordinary course of a trade or business of the CFC.

Effective Date -- The provision is effective with respect to transactions entered into after December 31, 2004.

U.S. Property Not to Include Certain Assets of CFCs

While the existing general rule is that "U.S. property" includes debt obligations of U.S. persons, the existing exceptions to that general rule (e.g., for obligations of unrelated corporations) are supplemented by the Act. Under the Act "U.S. property" also does not include:

- Securities (including those issued by related persons) that are acquired and held by a CFC in the ordinary course of its business as a dealer in

securities; or

- Obligations issued by unrelated noncorporate U.S. persons.

Effective Date -- The changes are effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Modification of Subpart F Exemption for Active Financing

The Act modifies the current exception to subpart F income for income of a CFC derived in the active conduct of a banking, financing or similar business, which now applies only to income derived from transactions substantially all of the activities in connection with which are conduced directly by the CFC. Under the Act, an activity performed by employees of a related person is treated, under certain circumstances, as conducted by the CFC for this purpose.

Effective Date -- The provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Other International Reforms

Repeal of Foreign Personal Holding Company Rules and Foreign Investment Company Rules

To simplify and further minimize overlapping provisions, the Act repeals the foreign personal holding company and foreign investment company rules; excludes foreign corporations from the application of the personal holding company rules; and creates a new category of subpart F foreign personal holding company income (FPHCI) to include personal services contract income.

Effective Date -- The provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Equal Treatment of Source of Interest Paid by Foreign Partnerships and Foreign Corporations

The Act provides that, if a foreign partnership is predominantly engaged in the active conduct of a trade or business outside the U.S., then interest paid by the partnership can be foreign-source income of the recipient, even if the partnership is also engaged in a U.S. trade or business. Foreign sourcing does not apply if the interest is paid by a U.S. trade or business of the partnership or the interest expense is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business.

Thus, for a partnership that meets this "predominantly engaged" test, recipients of its interest payments will source those payments according to rules similar to those applicable to interest payments from a foreign corporation.

Effective Date -- Effective for taxable years beginning after December 31, 2003.

Limitation of Withholding Tax on U.S. Dividends Paid to Puerto Rico Corporations

The Act reduces from 30 to 10 percent the U.S. withholding tax on U.S.-source dividends received by Puerto Rico corporations, subject to the same ownership and activity tests that apply for other possessions, and subject also to the continued 10 percent ceiling on Puerto Rico's withholding tax on the dividend income of U.S. corporations.

Effective Date -- This provision applies to dividends paid after the date of enactment.

Modification of Treatment of Certain REIT Distributions

The Act specifies that distributions by a REIT with respect to any class of stock regularly traded on an established U.S. securities market will not be treated as gain attributable to the disposition of a U.S. Real Property Interest if the shareholder holds a less-than-5 percent interest in that class of stock at any time during the taxable year. Such amounts will be taxed as an ordinary dividend distribution.

Effective Date -- The provision applies to taxable years beginning after the date of enactment.

Exclusion of Certain Horse Racing and Dog Racing Gambling Winnings From Gross Income of Nonresident Alien Individuals

The Act excludes from gross income, and exempts from U.S. tax, winnings received by a nonresident alien individual from a legal wagering transaction initiated outside the U.S. in a pari-mutuel pool with respect to a live horse race or dog race in the U.S., without regard to whether the foreign pool is merged with a U.S. pool.

Effective Date -- This provision applies to wagers made after the date of enactment.

Delay in Effective Date of Final Regulations Governing Exclusion of Income from International Operation of Ships or Aircraft

The Act delays the effective date of Treasury regulations on the exemption for income of a foreign corporation from the international operation of ships and aircraft that applies when the foreign corporation's country of residence grants an equivalent exemption to U.S. corporations. These regulations, published August 26, 2003, significantly revised the IRS approach to the reciprocal exemption and in many cases increased the exposure of foreign corporations to U.S. tax liability. They became effective, by their terms, for years beginning 30 days or more after August 26, 2003. Under the regulations, the reciprocal exemption generally is available only to a "qualified foreign corporation."

The Act generally delays the effective date of the regulations by a year, by providing that the regulations shall apply to tax years of foreign corporations seeking qualified foreign corporation status beginning after September 24, 2004.

Effective Date -- This provision has no effective date other than that provided for the regulations.

Eliminate Secondary Withholding Tax on Dividends Paid by Certain Foreign Corporations

Current law provides that a portion of a dividend paid by a foreign corporation generally is U.S.-source income to the recipient if 25 percent or more of the corporation's income during the previous three years was effectively connected with the conduct of a U.S. trade or business ("effectively connected income" or "ECI"). The provision, in effect, imposes a "secondary withholding tax" on a dividend paid to a foreign person by a foreign corporation that earned ECI and that is not or was not subject to the branch profits tax for the year in which it earned the profits out of which the dividend is paid.

The Act exempts from U.S. withholding tax any U.S.-source dividends paid by a foreign corporation, even if the earnings out of which the dividends are paid are not or were not subject to the branch profits tax (either because of a pre-1986 tax treaty or because the earnings relate to a pre-1986 year).

Effective Date -- The provision is effective for payments made after December 31, 2004.

Treatment of Certain Dividends of Regulated Investment Companies (RIC)

The Act temporarily (generally from 2005 through 2007) allows a RIC's foreign shareholders to derive the benefits of investing in U.S. debt instruments when the RIC invests in such instruments, and temporarily allows the RIC to pass through to foreign shareholders the capital gain character of its short-term, as well as long-term, capital gains. Therefore, a foreign corporation or a nonresident alien that would not be taxable in the U.S. on short-term capital gains, or that could benefit from the portfolio exemption, or other statutory exceptions from U.S. withholding or estate tax, on investments in debt instruments of U.S. issuers, may realize these benefits when the investment is indirect through a RIC (i.e., a U.S. corporation) that derives income from short-term capital gains or debt instruments.

The Act also provides that any distribution by a RIC to a foreign person will be treated as gain recognized by the foreign person from the sale or exchange of a U.S. Real Property Interest (USRPI) to the extent that the gain is attributable to gains from sales or exchanges by the RIC of an asset that is considered a USRPI.

Effective Date -- The provision applies to dividends with respect to tax years of RICs beginning after December 31, 2004. With respect to the treatment of RIC stock for estate tax purposes, this provision applies to estates of decedents dying after December 31, 2004. With respect to the treatment of RICs under section 897, the provision is effective after December 31, 2004.

Tonnage Tax Election for Income for International Shipping

The Act allows corporations to elect a "tonnage tax" instead of the U.S. corporate income tax on taxable income from certain shipping activities. In electing a tonnage tax, a corporation's gross income would not include income from qualifying shipping activities. Instead, the corporation would only be subject to tax on qualifying shipping activities at the maximum corporate income tax rate on its notional shipping income, which is based on the net tonnage of the corporation's qualifying vessels.

Notably, an electing corporation is only subject to the tonnage tax to the extent its taxable income from qualifying shipping activities would otherwise have been subject to tax under certain code sections. As a result, a foreign corporation is not subject to the tonnage tax regime to the extent its income from qualifying shipping activities is subject to an exclusion for certain shipping operations by foreign corporations pursuant to section 883(a)(1) or a U.S. treaty obligation.

Any item of loss, deduction, or credit that would be excluded from gross income is disallowed for an electing corporation. The election is revocable.

Effective Date -- The provision is effective for taxable years beginning after the date of enactment.

International Revenue Raisers

Tax Treatment of Expatriated Entities and Their Foreign Parents

The Act imposes severe limitations on the ability of the owners of a domestic entity to become instead the owners of a foreign corporation (an "inverted corporation") holding the properties of the former domestic entity. If the former owners of the domestic entity continue to own at least 80 percent of the inverted corporation, then, under the Act, the acquiring foreign corporation is treated as a domestic corporation for U.S. tax purposes. If the ownership is less than 80 percent but at least 60 percent, then the inverted corporation remains "foreign" for tax purposes as under present law, but the acquired domestic entities (and U.S. persons related thereto) are denied for at least 10 years the use of credits and deductions to shelter "inversion gains," such as gains realized in the inversion transaction, from U.S. tax. In either case, these consequences only apply if, after the acquisition by the inverted corporation, the expanded affiliated group that includes the inverted corporation fails a "substantial business activities" test: that is, it does not have substantial business activities (relative to its total business activities) in the country in which it was created, continued or organized.

The change in law is effective only for inversion transactions that were not at least half completed by March 4, 2003.

Effective Date -- Taxable years ending after March 4, 2003.

Excise Tax on Stock Compensation of Insiders in Expatriated Corporations

The Act imposes a nondeductible 15 percent excise tax (20 percent for years beginning after 2008) on "specified stock compensation" held at any time during a period near the date of an inversion transaction by a "disqualified individual" with respect to an "expatriated corporation" (i.e., a domestic entity described above). The provision applies only where actual holders of stock would be required to recognize stock gains in the expatriation, and where the exercise, sale or other payment of the compensation does not otherwise result in full income, gain or loss recognition during the period.

The term "disqualified individual" generally tracks the "insider" concept in section 16(a) of the 1934 Securities Exchange Act. "Specified stock compensation" is generally a payment, or right to payment, granted by the expatriated corporation (or a member of its expanded affiliated group) in connection with the performance of services, if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock in the corporation (or any such member). Such compensation excludes certain statutorily defined incentive stock options, and any payment, or right to payment from a qualified pension, profit-sharing or stock bonus plan, an employee annuity plan, a simplified employee pension, or a simple retirement account.

Effective Date -- The excise tax is effective March 4, 2003, except that periods before that date are not taken into account in applying the excise tax to specified stock compensation held or cancelled during the six-month period before the expatriation date.

Reporting of Taxable Mergers and Acquisitions

If a corporation acquires stock in, or property of, another corporation, and any shareholder of the acquired corporation is required to recognize gain (if any) as a result of the acquisition (making the transaction a "taxable acquisition" under the Act), then the acquiring corporation (or the acquired corporation, if required by the IRS) is required under the Act to report to the IRS the name and address of each shareholder of the acquired corporation that would be required to recognize gain (if any) as a result of the transaction, and the amount of money and the fair market value of property transferred to each such shareholder as part of the acquisition. Nominee shareholders will be required to report the same information regarding those for whom they serve as nominees.

The information provided to the IRS must also be provided to the shareholders on or before January 31 of the year following the calendar year during which the taxable acquisition occurred.

Current-law penalties for failure to comply with other information reporting requirements are applicable to failures to comply with this new provision.

Effective Date -- Acquisitions after the date of enactment.

Limitation on Transfer or Importation of Built-in Losses

Under current law, the basis of property received by a corporation in a nonrecognition transaction is generally equal to the adjusted basis of such property in the hands of the transferor, adjusted for gain or loss recognized in the transaction.

The Act makes two related but distinct changes to these rules. First, in a rule particularly affecting cross-border inbound transfers of property with a built-in loss in the aggregate, the Act steps down (or up) the transferee's basis in each item of the transferred property to fair market value. Second, in a rule applicable to all section 351 transactions, whether or not cross-border, the Act generally prevents the duplication of aggregate built-in loss in both the stock of the transferee held by the transferor and the assets received by the transferee. The transferor and transferee can jointly elect which will get its basis "stepped down."

Effective Date -- This provision applies to transactions and liquidations after the date of enactment.

Recapture of Overall Foreign Losses on Sale of CFC Stock

The Act subjects certain "applicable dispositions" of CFC stock to the same recapture rules that currently apply to dispositions of foreign trade or business assets: that is, otherwise applicable nonrecognition provisions are overridden, and the gain is resourced as U.S.-source income for foreign tax credit purposes. Subject to exceptions, e.g., for transactions in which direct and indirect ownership of the CFC's stock does not change, an applicable disposition is any disposition of any share of stock in a CFC in a transaction, or series of transactions, if immediately before such transaction (or series of transactions) the taxpayer owned more than 50 percent (by vote or value) of the stock of the CFC.

Effective Date -- The provision applies to dispositions after the date of enactment.

Clarification of Banking Business for Purposes of Determining Investment of Earnings in U.S. Property

The Act limits the existing exception from the subpart F definition of U.S. property that applies to obligations of U.S. persons that are also "deposits with persons carrying on the banking business."

Under the Act, the exception can only be met where the person either is a depositary that is a "bank" as defined in section 2(c) of the Bank Holding Company Act of 1956, or an 80 percent-owned subsidiary of a "bank holding company" or "financial holding company," as defined in the same statute.

Effective Date -- The provision takes effect on the date of enactment.

Prevention of Mismatching of Deductions and Income Inclusions in Transactions With Related Foreign Persons

Current law generally puts a U.S. taxpayer on the cash method of accounting with respect to amounts owed to a related foreign person. An exception is provided where the related foreign person is a CFC, PFIC or FPHC, in which case the U.S. taxpayer can deduct accrued amounts as of the day on which the amount is includible in the income of the CFC, PFIC or FPHC.

Under the Act, an accrued but unpaid amount due from a U.S. taxpayer to a related CFC or PFIC is not deductible until a corresponding amount is included in the gross income of a U.S. person who owns stock (directly or through a foreign entity) in the CFC or PFIC.

Effective Date -- The provision is effective for payments accrued on or after the date of enactment.

Minimum Holding Period for Foreign Tax Credit on Withholding Taxes on Income Other than Dividends

The Act denies foreign tax credits for withholding taxes on any non-dividend item of income or gain with respect to property, if the income recipient has held the property for 15 days or less during the 30-day period beginning on the date that is 15 days before the date on which the right to received payment of such item arises. (A similar rule already applies to dividends.) Credits for withholding taxes on such other items are also disallowed to the extent the income recipient is under an obligation to make related payments with respect to positions on substantially similar or related property.

The provision does not apply to certain taxes paid to a foreign country on income or gain that is received with respect to property held by a dealer.

Effective Date -- The provision applies to amounts paid or accrued more than 30 days after the date of enactment of the Act.

Prohibition on Nonrecognition of Gain through Complete Liquidation of Holding Company

The Act provides for dividend treatment of a distribution to a foreign corporation in complete liquidation of the domestic common parent of a U.S. affiliated group, if substantially all of the liquidating U.S. corporation's assets are stock of affiliates, and the liquidating U.S. corporation has not been in existence during the entire five years preceding the date of the liquidation.

Effective Date -- This provision applies to distributions in complete liquidation occurring on or after the date of the enactment.

Effectively Connected Income to Include Certain Foreign-Source Income

The Act brings foreign-source items that are economic equivalents of foreign-source rents, royalties, interest, dividends and gains that can be U.S.-effectively connected income (ECI) into the class of income that is ECI if such items are attributable to an office or other fixed place of business in the U.S. and otherwise meet the relevant criteria to be treated as ECI.

Effective Date -- The provision applies to taxable years beginning after the date of enactment.

Reinsurance of U.S. Risks in Foreign Jurisdictions

Section 845(a) grants the Treasury Secretary authority to allocate certain items among related persons that are parties to a reinsurance agreement; to recharacterize the items; or to make any other adjustment. This authority may be exercised where the Secretary determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper source and character of the taxable income of each person. The Act amends the wording of the grant of authority to the Secretary. Under the Act, the word "amount" is added to the list of reasons for allocation, recharacterization, or adjustment, so that the authority may be exercised where the Secretary determines that such allocation, recharacterization or adjustment is necessary to reflect the proper amount, source or character of the taxable income (or any item related to such taxable income) of each related person.

Effective Date -- The provision applies to any risk reinsured after date of enactment.

Application of Retirement Plan Basis Rules to Nonresident Aliens

The Act amends the rules for determining a nonresident alien's basis in a retirement plan account for purposes of computing the taxable portion of a distribution from a retirement plan and for purposes of calculating gain from the sale of property received as compensation for services (e.g. stock). In general, the rules deny basis when a distribution of property is received for services performed outside the United States without the imposition of tax by the foreign jurisdiction or the United States.

Effective Date -- The provision is effective for distributions and sales occurring on or after the date of enactment.

Residence and Source Rules Relating to United States Possessions

The Act would make it more difficult to qualify as a bona fide resident of a U.S. possession and thereby become entitled to special U.S. income tax rules that apply to U.S. persons who are bona fide residents of certain U.S. possessions, including Puerto Rico, the Virgin Islands, Guam, Northern Mariana Islands and America Samoa.

In addition, the Act provides that the determination of whether income is from sources within one of the possessions, or is effectively connected with the conduct of a trade or business within such possession, will be made under rules similar to those rules used for determining whether income is U.S.-source income or effectively connected with the conduct of a U.S. trade or business.

Finally, the Act provides that, under reporting requirements to be prescribed by the Secretary, an individual claiming, for U.S. income tax reporting purposes, to have become, or ceased to be, a bona fide resident of a possession for any taxable year must file notice of such position with the IRS.

Effective Date -- The provision is effective for taxable years ending after the date of enactment.

Tax Rules on Expatriation of Individuals

Under the Act, a former citizen or long-term resident is subject to the alternative tax regime (in the case of income tax, 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.

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. An individual generally resumes 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. Limited exceptions to this rule apply.

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

International Taxation Studies

The Act provides for several studies by the Treasury Department in the area of international taxation including:

- **Earnings Stripping --** The Treasury Department is required to conduct a study of the current-law earnings stripping rules and provide specific recommendations to Congress no later than June 30, 2005. Issues that Treasury is required to study include: the effectiveness of earnings stripping rules in preventing the shifting of income outside the United States; whether deficiencies in these rules have the effect of placing U.S.-based businesses at a competitive disadvantage relative to foreign-based businesses; the impact of earnings stripping activities on the U.S. tax base; and whether changes to the earnings stripping rules would affect jobs in the United States.
- **Transfer Pricing --** The Treasury Department is required to examine the effectiveness of the transfer pricing rules with an emphasis on transactions involving intangible property and report to Congress no later than June 30, 2005.
- **Income Tax Treaties --** The Treasury Department is required to examine income tax treaties to which the United States is a party, focusing on identifying any inappropriate reductions in withholding tax or opportunities for abuse that may exist. The study is due to Congress no later than June 30, 2005.
- **Inversions --** The Treasury Department is required to examine the impact of the Act on inversion transactions and report to Congress no later than December 31, 2006.

Chapter 5:

Tax Shelter, Anti-Abuse & IRS Administrative Provisions

The tax shelter provisions in the Act reflect, and build on, an approach that the Treasury Department introduced in March 2002. Treasury concluded that a key to curtailing the use of abusive tax-avoidance transactions is to accumulate much more taxpayer transaction information in the course of the annual tax return filings. Armed with this additional information, the IRS should be better poised to identify abusive transactions sooner and pursue enforcement actions more quickly. To implement this strategy, Treasury took steps to establish clearer disclosure rules and recommended several legislative changes to penalize nondisclosure.

Significantly, the Act does not contain a number of the more controversial anti-tax shelter rules that were included in the Senate version of the legislation. These had been criticized as imposing unnecessary costs or uncertainty on taxpayers and advisors engaging in conduct that does not threaten the integrity of the tax system. Instead, the conferees appear to have concluded that the initiatives undertaken by Treasury and the IRS are effective and should be supported by tough nondisclosure penalties designed to assure full compliance with the disclosure system. Thus, the Act does not contain an ill-defined penalty relating to transactions that lack economic substance, requirements that CEOs sign tax returns or certify their tax compliance processes, and changes in preparer penalties that would significantly raise the support that is required for positions before a preparer can sign a return, thereby increasing compliance costs.

The Act (1) requires greater tax shelter disclosure and increases penalties related to tax shelter activity, (2) targets specific tax-avoidance transactions, and (3) strengthens IRS administrative processes. Congress sees these provisions not as tax increases, but as tools to promote enforcement of existing law or its intended results. In contrast, taxpayers may feel that many of the provisions will lead to increased reporting requirements, increased uncertainty, or increased IRS examination controversy.

Shelter-Related Disclosure and Penalties

Taxpayers who fail to disclose reportable transactions to the IRS will face significant consequences, including a new nondisclosure penalty. Under current law, there are two types of reportable transactions that require disclosure:

- **Listed Transactions --** These are transactions that have been specifically identified in IRS published guidance as tax-avoidance transactions as well as transactions that (1) are expected to produce the same or similar tax consequences and (2) are either factually similar to or based on the same or similar tax strategy as a listed transaction.
- **Other Reportable Transactions --** These are transactions that must be disclosed if they: (1) are offered to a taxpayer under conditions of confidentiality; (2) provide the taxpayer with contractual protection if the intended tax consequences of the transaction are not sustained; (3) generate section 165 losses that exceed a certain dollar threshold; (4) are undertaken by business entities that have $250 million or more in gross assets at the end of any financial accounting period that ends during the tax year in which the transaction occurs and result in book-tax differences that exceed $10 million; or (5) involve a brief asset holding period.

The New Nondisclosure Penalty

The Act imposes a strict liability penalty on taxpayers who do not disclose the required information concerning a reportable transaction. If the taxpayer is a natural person, the penalty is $10,000 ($100,000 in the case of a listed transaction). The penalty increases to $50,000 for other types of taxpayers ($200,000 in the case of a listed transaction).

The penalty may be rescinded or abated only in the case of a nonlisted transaction and only if the Commissioner finds that such action would promote compliance and effective tax administration.

Effective Date -- The provision is effective for returns due after the date of enactment.

The legislation does not define the due date to which the effective date provision refers. This means that, if the president signs this legislation on or before Octo-

ber 15, 2004, the IRS may consider imposing penalties on taxpayers failing to make disclosures on returns that were extended to October 15.

Accuracy-Related Penalties

Reportable Transactions

The Act creates a separate accuracy-related penalty for reportable transactions. A penalty of 30 percent of the tax understatement applies if the taxpayer fails to disclose a listed transaction or other reportable transaction with a significant tax-avoidance purpose. With disclosure, a lower penalty of 20 percent of the tax understatement applies.

This penalty may be waived for reasonable cause, but reasonable cause will exist only if:

- The taxpayer made adequate disclosure;
- The position, in fact, was supported by substantial authority; and
- The taxpayer reasonably believed the position was more-likely-than-not correct.

Stated differently, even if a taxpayer reasonably believed that its position was correct, the penalty cannot be waived in the absence of disclosure.

Further, even if disclosure occurred, the penalty cannot be waived if the taxpayer's belief in its position was based on a disqualified opinion. Such opinions include opinions provided by:

- The promoters;
- Any advisors introduced by promoters; or
- Any independent advisor that helped to implement the transaction (for example, a law firm doing contracts or securities filings).

Effective Date -- The provision is effective for taxable years ending after the date of enactment.

Thus, a transaction that was completed before the date of enactment can give rise to a penalty if it creates an understatement on a return, such as a return for calendar year 2004, for a year ending after that date.

Nonreportable Transactions

The Act modifies the penalty for substantial understatements of income tax attributable to transactions that do not fall within one of the reportable transaction categories. For corporations (other than an S corporation or personal holding company), the Act changes the substantial understatement threshold to the lesser of 10 percent of the correct liability (or, if greater $10,000), or $10 million.

Effective Date -- The provision is effective for taxable years beginning after the date of enactment.

Disclosure of Penalties to the Securities and Exchange Commission

Public companies must disclose the imposition of certain penalties relating to disclosure and accuracy in their reports to the Securities and Exchange Commission. These are: (1) the $200,000 nondisclosure penalty if imposed with respect to a listed transaction; (2) penalties imposed for understatements from undisclosed listed transactions or undisclosed reportable transactions with a significant tax-avoidance purpose; and (3) a gross valuation misstatement penalty with respect to undisclosed listed transactions or undisclosed reportable transactions with a significant tax-avoidance purpose.

Other Shelter-Related Measures

Extended Statute of Limitations

For taxpayers failing to disclose a listed transaction, the statute of limitations for assessments and collection actions concerning the transaction is extended to one year after the government is provided with the information.

Effective Date -- This provision applies to taxable years for which the period for assessing a deficiency did not expire before the date of enactment.

This provision would allow extensions of the statute of limitation on returns that have already been filed, if the required disclosures were not made.

Denial of Interest Deduction

The Act denies a deduction for interest on underpayments attributable to undisclosed listed transactions or undisclosed reportable transactions with a significant tax-avoidance purpose.

Effective Date -- This provision applies to taxable years beginning after the date of enactment.

Suspension of Interest Accrual

Under the Act, the accrual of interest is suspended when a taxpayer has not been notified of a tax liability. This provision does not apply, however, to any interest, pen-

alty, addition to tax, or additional amount pertaining to a listed transaction or an undisclosed reportable transaction with a significant tax-avoidance purpose.

Effective Date -- Generally, this provision applies to taxable years beginning after December 31, 2003. However, for listed transactions and reportable transactions with a significant tax-avoidance purpose, the provision applies to interest accruing after October 3, 2004.

Reining in Promoters

Congress believes that much of the tax shelter problem that it sees is driven by the supply of tax shelters created by promoters and advisors rather than demand from taxpayers. To discipline promoters, the Act increases penalties, requires greater transparency regarding transactions presented to taxpayers, and permits the Treasury to enjoin or bar offending conduct. In addition, as described above, the Act precludes the use of opinions written by promoters or other material advisors in defense against penalties.

Increased Penalty for Promoting

The Act increases the existing penalty for making or providing a false or fraudulent statement about tax benefits in connection with the organization or sale of an interest in any entity or plan from $1,000 to 50 percent of the gross income derived or to be derived from the activity.

Effective Date -- The provision applies to activities after the date of enactment.

Disclosure of Transactions by Promoters

The Act replaces the existing rules requiring promoters to register a potentially abusive transaction with a disclosure requirement that applies to a much broader group of "material advisors." The material advisor will be responsible for filing an information return disclosing the reportable transaction to the IRS and for maintaining lists of those advised with respect to the transactions.

The Act defines a material advisor as anyone who (1) provided material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction; and (2) directly or indirectly derived more than $250,000 in gross income -- or $50,000 if the tax benefits are for a natural person -- from providing the service.

Limitation of Confidentiality Privilege

Under the Act, the confidentiality privilege between a federally authorized tax practitioner and a taxpayer will not apply to written communications concerning the taxpayer's direct or indirect participation in a tax shelter.

Effective Date -- This provision applies to communications made on or after the date of enactment.

Penalties for Failure to Meet Promoter Information Requirement

Furnishing Information to IRS -- A penalty equal to the greater of $200,000 or 50 percent of the gross income generated by the transaction applies for failure to furnish information concerning a listed transaction to the IRS. A $50,000 penalty applies for failure to furnish information concerning other reportable transactions.

Effective Date -- This provision applies to returns due after the date of enactment.

Maintaining Lists -- A penalty of $10,000 per day applies for failure to provide the list to the Treasury Secretary within 20 business days after receiving a written request.

Effective Date -- This provision applies to requests made after the date of enactment.

Limited Further Activity by Promoters

Enjoining Conduct -- The Act gives the Treasury Department the authority to enjoin conduct related to promoting abusive tax shelters, failing to furnish information regarding reportable transactions, and failing to maintain lists of investors in reportable transactions.

Effective Date -- The provision applies after the date of enactment.

Regulation of Practice Before Treasury -- The Act expands the sanctions available to Treasury when there is a violation of the IRS standards of professional conduct (the Circular 230 standards). Treasury is permitted to censure and to impose monetary penalties on individuals and their firms.

Effective Date -- This provision applies to actions taken after the date of enactment.

Specific Anti-Abuse Revenue Raisers

The Act shuts down a number of high-profile transactions that members of Congress believe take inappropriate advantage of inconsistencies in the existing tax laws and may go undetected or unaddressed under the existing enforcement regime. Many of these provisions

were the subject of substantial adverse publicity arising either from the Joint Committee on Taxation's review of tax transactions undertaken by Enron or from lawsuits brought by taxpayers against promoters.

Sale-In, Lease-Out (SILO) Transactions

The Act takes aim at the use of SILO and related transactions to shelter billions of corporate dollars from U.S. tax. These transactions generally involve a U. S. corporation's purchase and concurrent leaseback of assets. Dramatic media coverage of transactions involving infrastructure such as subway systems, stadiums, and power plants from a domestic or foreign municipality (or other tax-exempt entity) generated a stern response from Congress.

Critics in Congress and the administration find these arrangements troubling because in the early years of the lease, the corporate lessor's deductions (for depreciation, interest incurred on the loan that financed the purchase of the property, and transaction costs) greatly exceed the income from the property. The disparity has led Treasury and a number of lawmakers to conclude that SILO transactions lack economic substance and have no meaningful financial or economic utility beyond transferring tax benefits from tax-indifferent parties to U.S. corporations. Proponents of the transactions have argued, to little avail, that the fees received by state and local governments for participating in SILO arrangements are a much-needed source of capital.

Generally, the legislation diminishes the attractiveness of SILO transactions by:

- Requiring that the useful life of subject property be the longer of the property's assigned class life or 125 percent of the lease term. Subject property is qualified technology property, software, and section 197 intangibles leased to a tax-exempt entity.
- Extending the length of the lease term for purposes of rules relating to leases to governments and other tax-exempt entities to include the term of all related service contracts; and
- Disallowing tax-exempt use losses in excess of income from the leased property for any tax year, and treating the disallowed loss as a deduction with respect to the property in the next taxable year.

Effective Date -- This provision is generally applicable to leases entered into after March 12, 2004. However, there is an exception for domestic property subject to a lease that was submitted to the Federal Transit Administration after June 30, 2003, and before March 13, 2004, and is approved by the agency before January 1, 2005. Provisions relating to intangible assets and Indian tribal governments are effective for leases entered into after October 3, 2004.

Limitation on Transfer or Importation of Built-in Losses

The Act makes two related but distinct changes to these rules governing the basis of property received by a corporation in a nonrecognition transaction under sections 351, 368(a)(1), or 332:

- First, in a rule particularly affecting cross-border inbound transfers of property with a built-in loss in the aggregate, the Act steps down (or up) the transferee's basis in each item of the transferred property to fair market value.
- Second, in a rule applicable to all section 351 transactions generally, whether or not cross-border, the Act generally prevents the duplication of aggregate built-in loss in both the stock of the transferee held by the transferor and the assets received by the transferee.

Reorganizations and Section 351 Exchanges That Import Built-in Losses -- Under the Act, new section 362(e)(1) applies to a transaction described in sections 351 or 368(a)(1) where there is "an importation of a net built-in loss." (That is, property is transferred in a transaction with respect to which the transferee, but not the transferor, is subject to U.S. income tax on gain or loss at the time of the transfer, and the aggregate adjusted bases of the property transferred exceeds its fair market value immediately after the transaction.) In such a case, the Act provides that the basis of each property transferred is its fair market value immediately after the transaction.

Liquidations That Import Built-in Losses -- Similarly, the Act amends section 334(b) to provide that, in the case of a section 332 liquidation, the basis of the property in the hands of the distributee is its fair market value if the liquidating corporation is foreign, the distributee is domestic, and the aggregate adjusted bases of transferred property (with respect to which the domestic parent, but not the foreign subsidiary, is subject to U.S. income tax on gain or loss at the time of the transfer) exceed its fair market value.

Elimination of Loss Duplication in Section 351 Transactions Generally -- In a section 351 transaction in which there is no importation of a net built-in loss (and thus section 362(e)(1) does not apply), and where the aggregate adjusted bases of the transferred property exceed fair market value, new section 362(e)(2) generally limits the transferee's aggregate adjusted basis of

the property transferred to the fair market value of such property. (The aggregate reduction in basis is allocated among the property transferred in proportion to their respective built-in losses.) However, as an alternative to basis reduction by the transferee, the transferor and transferee can jointly elect to reduce the transferor's basis of the stock received in the transaction to its fair market value.

Effective Date -- This provision applies to transactions and liquidations after the date of enactment.

Observation

This provision builds on previous congressional efforts to limit the ability of taxpayers to engage in specific transactions that duplicate a single economic loss and subsequently deduct those losses more than once.

Repeal of Special Rules for FASITs

The Act repeals the rules for taxing financial asset securitization investment trusts (FASITs). The provision also modifies certain definitions relating to real estate mortgage investment conduits (REMICs) so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC.

Effective Date -- The repeal is effective on January 1, 2005. For FASITs in existence on that date, a transition rule provides that regular interests issued by the FASIT before the effective date of the repeal will continue to remain outstanding in accordance with their original terms of issuance.

Interest on Convertible Debt

The provision expands the present-law disallowance of interest deductions on certain corporate debt instruments to include corporate debt that is payable in, or by reference to the value of, equity held by the issuer (or any related party) in any other person. This provision does not apply to debt issued by a dealer in securities (or a related party) that is payable in, or by reference to the value of, equity (other than equity of the issuer or a related party) held by the dealer in its capacity as a dealer in securities.

Effective Date -- This provision is effective for debt instruments issued after October 3, 2004.

Partnership Basis Adjustment in Stock of Corporate Partner

The Act provides that, when applying the basis allocation rules under section 755 to a distribution in liquidation of a partner's interest, a partnership cannot decrease the basis of any corporate stock of a partner or any stock of a person related to the partner. Any decreases that would have been allocated to such stock absent this provision are allocated to other partnership assets. If the decrease exceeds the basis of all other partnership assets, then the excess amount is recognized by the partnership as gain.

Effective Date -- The provision is effective for distributions after the date of enactment.

Disallowance of Partnership Loss Transfers

Under the Act, built-in losses may only be taken into account by a contributing partner. For allocating items to partners other than the contributing partner, the basis of contributed property is treated at fair market value at the time of the contribution (except as provided by regulations).

The Act requires a basis adjustment under section 734(b) in the case of a distribution with respect to which there is a substantial basis reduction -- that is, a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a section 754 election were in effect.

For transfers of partnership interests, when there is a substantial built-in loss, the Act states that the basis adjustment rules under section 743 are mandatory. A substantial built-in loss exists if the partnership's adjusted basis in its property exceeds the fair market value of the partnership property by more than $250,000.

For some transfers, the Act does not require certain electing investment partnerships to make basis adjustments because of a substantial built-in loss. A partner-level loss limitation rule applies instead.

In the case of a transfer, the Act does not require securitization partnerships to make basis adjustments because of built-in losses. In this case, the basis adjustment remains elective.

Effective Date -- The provision applies to contributions, distributions, and transfers after the date of enactment. The special transition rule for transfers applies to electing investment partnerships in existence on June 4, 2004.

Charitable Contributions of Patents and Intellectual Property

The Act modifies the treatment of charitable deductions for donations of intellectual property. Under the provision, 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 lesser of the taxpayer's basis in the contributed property or the fair market value of the property. The taxpayer may also claim a charitable deduction for certain additional amounts in the year of contribution or in subsequent taxable years, based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed property.

This additional charitable deduction is allowed only to the extent that the aggregate of the amounts that are calculated based on the specified percentage exceed the amount of the deduction claimed upon the contribution of the patent or intellectual property. By establishing a sliding scale for the deduction, Congress has given donors the opportunity for additional charitable contribution deductions, but only to the extent that the donated property provides income for the charitable organization.

Effective Date -- The provision is effective for contributions made after June 3, 2004.

Observation

This provision grew out of congressional concerns that contributions of intellectual property such as patents, trademarks, trade names, trade secrets, copyrights, know-how, software, or applications of or registration of such property to charitable organizations are highly speculative for the charitable organizations.

Contributions of Property

The Act requires increased donor reporting for contributions of noncash property other than cash, inventory, and publicly traded securities. Under the change, C corporations must obtain appraisals for donated property (something already required under current law for individuals, partnerships, S corporations, and other entities) if the amount of the donation exceeds $5,000. If the claimed value exceeds $500,000, the appraisal must be attached to the donor's tax return. The IRS will deny the deduction if the donor has not complied with the reporting requirements.

Effective Date -- The provision is effective for contributions made after June 3, 2004. A C corporation with a fiscal year ending after June 3, 2004, and an original due date for the return after August 18, 2004, is subject to this provision.

Donations of Vehicles

For contributions of vehicles -- including automobiles, boats, and airplanes -- with a claimed value exceeding $500, the Act limits the charitable deduction to the gross proceeds received by the charitable organization upon subsequent sale of the vehicle. It also requires contemporaneous written acknowledgement by the donee of the same donations. If the vehicle is not sold, the donee must provide certification of the intended use of the property and the duration of the use. Taxpayers who fail to provide the acknowledgement or who provide false or fraudulent information will face penalties.

Effective Date -- The provision is effective for contributions made after December 31, 2004.

Observation

Situations in which a charity received only a fraction of the sales price of a donated vehicle first came to light for Congress at a June 22, 2004, Senate Finance Committee hearing. This has led members of Congress to further scrutinize other possible abuses in the charitable giving area.

Definition of Nonqualified Preferred Stock

The Act clarifies the definition of preferred stock for purposes of defining nonqualified preferred stock in section 351(g). Stock for which there is not a real and meaningful likelihood of actually participating in the earnings and profits of the corporation is treated as preferred stock. For example, instruments that are preferred on liquidation and are entitled to the same dividends as may be declared on common stock do not escape being nonqualified preferred stock by reason of that right if in fact the corporation does not pay dividends to either its common or preferred stockholders.

This revised definition of preferred stock applies only for purposes of section 351(g). Note, however, that other code sections -- for example, section 354 -- refer to the section 351(g) definition of nonqualified preferred stock, and thus will be affected by this change as well.

Effective Date -- The provision is effective for transactions after May 14, 2003.

Tax Administration Measures

The Act contains a variety of measures to strengthen the IRS's ability to enforce the tax laws and collect taxes.

Failure to Report Foreign Accounts

The Act authorizes a civil penalty of up to $10,000 to be imposed on individuals that fail to report their interests in foreign financial accounts. Willful violations of the reporting requirement are subject to a penalty of $100,000 or more.

Effective Date -- This provision is effective on the date of enactment.

Provisions to Improve Tax Collection Efficiency

- **Partial Payments of Tax Liabilities --** The Act permits the IRS to enter into installment agreements for less than the taxpayer's full tax liability. (**Effective Date --** This provision is effective on the date of enactment.)
- **Levy on Federal Vendor Payments** -- The Act increases the portion of a federal vendor payment that may be subject to a continuing levy for unpaid taxes to 100 percent of the payment. (**Effective Date --** This provision is effective on the date of enactment.)
- **Deposits to Stop Running of Interest --** The Act permits taxpayers to make a cash deposit with the IRS to pay a potential liability. Accrual of interest is suspended on the portion of the underpayment satisfied by the deposit beginning on the date of the deposit. (**Effective Date --** This provision applies to deposits made after the date of enactment. However, amounts already on deposit as of the date of enactment will be treated as deposited on the date the taxpayer identifies the amount as a deposit made pursuant to this provision.)
- **Tax Collection Contracts --** The Act permits the IRS to use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type and to arrange payment of those taxes by the taxpayers. (**Effective Date --** This provision is effective on the date of enactment.)

Other Administrative Measures

Consolidated Return Regulation Authority

The Act authorizes the Treasury Department to publish regulations that would treat corporations filing consolidated returns differently from corporations filing separate returns. The Act prevents taxpayers from using the rationale of the taxpayer-friendly decision in Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001) to argue that other consolidated return regulations (including already-existing regulations) are invalid.

In Rite Aid, the Federal Circuit invalidated the "duplicated loss" factor of the consolidated return loss disallowance regulations, which disallowed certain losses on the sale of a subsidiary's stock. This provision clarifies that the Federal Circuit's decision has no precedential effect for application to other consolidated return regulations. The Act does not overrule the decision in Rite Aid with respect to the application of the duplicated loss factor to the specific facts of that case.

Effective Date -- The provision is effective for all taxable years, whether beginning on, before, or after the date of enactment.

IRS User Fees

The Act extends the IRS's authority to charge fees for providing rulings, opinions, and determination letters to September 30, 2014.

Effective Date -- The provision is effective for requests made after the date of enactment.

Customs User Fees

The Act extends the passenger and conveyance processing fees and the merchandise processing fees through September 30, 2014. Under current law, these fees are set to expire on March 1, 2005. Significantly, for fiscal years beginning after September 30, 2005, the Treasury Secretary is to charge fees that reflect the costs of providing Customs services in connection with the activity for which the fees are being assessed. Notably, however, the provision includes nonbinding Sense of the Congress language stating that the fees currently being charged are reasonably related to services being provided. Finally, the provision requires the Treasury Secretary to conduct a Customs user fee study for Congress that recommends fees to be eliminated and the appropriate rate of retained fees. The study is due by September 30, 2005.

Effective Date -- The provision is effective on the date of enactment.

Taxable Mergers and Acquisitions

The Act establishes certain reporting requirements in connection with taxable mergers and acquisitions. If shareholders of a corporation recognize gain or loss because the corporation's assets or stock were acquired by a second corporation, then the acquiring corporation is required to file a return containing certain specified information, including:

- A description of the transaction;
- The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction;
- The amount of money and the value of stock or other consideration paid to each shareholder; and
- Any other information requested by Treasury.

Alternatively, a stock transfer agent who records transfers of stock in such a transaction may file the return in lieu of the acquiring corporation. The Act allows the Secretary of the Treasury to prescribe that the acquired corporation file the return. Finally, each person required to make a return must also furnish each shareholder with the required information on or before January 31 of the year following the calendar year during which the transaction occurred.

Effective Date -- The provision is effective for acquisitions occurring after the date of enactment.

Observation

As is the case with other information reporting requirements in the Act, Congress believes that greater information reporting of taxable non-cash transactions will lead to improved administration of the tax law.

Extension of Declaratory Judgment Procedures to Farmers' Cooperatives

The Act permits a cooperative to seek judicial review of an IRS determination concerning its classification as a tax-exempt farmers' cooperative under section 521.

Effective Date -- This provision applies to pleadings filed after the date of the enactment.

Fuel Tax Fraud Prevention

The Act includes provisions to:

- Eliminate manual dyeing of fuel and require dyeing by a mechanical system. (This provision applies with respect to terminals that offer dyed fuel.) The provision also includes an additional set of penalties for violation of the new rules. It denies administrative review to repeat offenders and extends present-law penalties to any person who knows that the strength or composition of any dye or marking in any dye has been altered and who sells that fuel for any use that the person knows is taxable. (**Effective Date --** The provision is generally effective 180 days after the Treasury Secretary issues required regulations. The regulations are required to be issued within 180 days of enactment.)
- Eliminate the ability of intercity bus operators to buy dyed diesel fuel and self-assess the 7.4 cents per gallon tax. Operators of these buses must purchase clear fuel at a 24.4 cents per gallon tax rate and seek a refund of tax. (**Effective Date --** The provision is effective for fuel sold after December 31, 2004.)
- Expand the scope of an IRS inspection to include any books, records, or shipping papers regarding taxable fuel located in any authorized inspection location. (**Effective Date --** The provision is effective on the date of enactment.)
- Impose a $1,000 penalty for refusing to allow the IRS to inspect any place where taxable fuel is produced or stored. The new penalty is imposed in addition to a $1,000 present-law sanction. (**Effective Date --** The provision is effective on January 1, 2005.)
- Require that for a bulk transfer of a taxable fuel to be exempt from tax, any pipeline or vessel operator that is a party to the transfer be registered. (**Effective Date --** The provision is generally effective on March 1, 2005.)
- Require that every operator of a vessel who is required to register must display proof of registration on each vessel used to transport fuel. Penalties apply for failure to register. (**Effective Date --** The provision is generally effective on January 1, 2005. Penalty provisions are effective for penalties imposed after December 31, 2004.)
- Require registration by any person who operates a terminal or refinery within a foreign trade zone or a Customs bonded storage facility. (**Effective Date --** The provision is effective January 1, 2005.)

- Impose a new assessable penalty for failure to file a report or furnish information for a report required by the ExSTARS system. (**Effective Date --** The provision is effective for penalties imposed after December 31, 2004.)
- Require any person who must report under the ExSTARS system and who has 25 or more reportable transactions in a month to report electronically. (**Effective Date --** The provision is effective on January 1, 2006.)
- Permit two registered parties to switch position-holder status in fuel within a registered terminal (thereby relieving the person originally owning the fuel from tax liability) under certain conditions. (**Effective Date --** The provision is effective on the date of enactment.)
- Add the following new categories to the definition of diesel fuel: (1) any liquid -- other than gasoline -- that is suitable for use as a fuel in a diesel-powered highway vehicle or train; (2) transmix; and (3) diesel fuel blend stocks identified by the Treasury Secretary. (**Effective Date --** The proposal is effective for fuel removed, sold, or used after December 31, 2004.)
- Mandate a Treasury study on taxable fuel compliance. (**Effective Date --** The report is due no later than January 31, 2005.)

Chapter 6:

Other Tax Cuts

Depreciation and Other Cost Recovery Provisions

Depreciation Lives for Leasehold Improvements and Restaurants

Leasehold Improvements -- The Act provides a 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006. The current-law definition of qualified leasehold improvement property is modified to provide that if a lessor makes an improvement that qualifies for the reduced recovery period, a subsequent owner of the improvement will not qualify for the reduced recovery period.

Effective Date -- The provision is effective for property placed in service after the date of enactment and before 2006.

Restaurant Property -- The Act provides a 15-year recovery period for qualified restaurant property placed in service before January 1, 2006. Qualified restaurant property is any improvement to a building if (1) the improvement is placed in service more than three years after the date the building was first placed in service and (2) more than 50 percent of the building's square footage is devoted to the preparation, seating, and consumption of prepared meals.

Effective Date -- The provision is effective for property placed in service after the date of enactment and before 2006.

Observation

To the extent it is financially feasible, taxpayers should consider the potential benefit of accelerate improvements, as the reduction in the recovery period is only available through 2005.

Bonus Depreciation

Pursuant to tax legislation enacted in 2002 and 2003, certain property is 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 be placed in service before January 1, 2005, to qualify for a bonus depreciation deduction. Certain types of property, however, may qualify for a bonus depreciation deduction if placed in service before January 1, 2006.

The Act changes current-law bonus depreciation rules regarding noncommercial aircraft and property subject to syndication.

Noncommercial Aircraft -- The Act allows certain noncommercial aircraft to benefit from the extended January 1, 2006, placed-in-service date for bonus depreciation purposes, provided that they:

- Are acquired by the taxpayer during the applicable time period as under present law;
- Meet the appropriate placed-in-service date requirements;
- Are not tangible personal property used in the trade or business of transporting persons or property (except for agricultural or firefighting purposes);
- Are purchased by a purchaser who, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of 10 percent of the cost, or $100,000; and
- Have an estimated production period exceeding four months and a cost exceeding $200,000.

Effective Date -- The provision is effective for property placed in service after September 10, 2001. However, because the property described by the provision qualifies for the additional first-year depreciation deduction under present law if it is placed in service before January 1, 2005, the provision will only modify the treatment of property placed in service during calendar year 2005.

Property Subject to Syndication -- The Act provides a special placed-in-service rule for bonus depreciation for certain property subject to syndication. Specifically, for multiple units of property subject to the same lease, a special rule provides that property will be considered to be placed in service on the date of sale if it is sold within three months after the final unit is placed in service (if the period between the time the first and last units are placed in service is not longer than 12 months).

Effective Date -- The provision is effective for property sold after June 4, 2004.

Accounting Method for Naval Shipbuilders

The Act permits naval shipbuilders to use the 40/60 percentage-of-completion/capitalized cost method of accounting for reporting income during the first five years of a qualifying contract. Any tax benefit from using the method must be recaptured in the sixth year.

A qualified contract is one related to the construction, within the United States, of a federally ordered ship or submarine. The builder must expect that the acceptance date will occur within nine years after the construction begins.

Effective Date -- The provision is effective for contracts for which the construction begins after the date of enactment.

Green Building and Sustainable Project Bonds

The Act establishes a $2 billion tax-exempt bond authority for qualified green building and sustainable design projects.

Effective Date -- The provision is effective for bonds issued after December 31, 2004, and bonds issued before October 1, 2009.

Class Life for Track Facilities

The Act provides a seven-year recovery period for permanent motorsports racetrack complexes.

Effective Date -- The provision is effective for property placed in service after the date of enactment but before January 1, 2008.

Timber Manufacturing Relief

Provisions for the timber industry include:

- **Capital Gain Treatment of Timber Sales --** The Act applies capital gains treatment to outright sales of timber by a land owner. Under the provision, land owners selling timber no longer have to retain an economic interest in the timber to treat gains as capital gain. (**Effective Date --** The provision is effective for sales of timber after December 31, 2004.)
- **Expensing of Reforestation Expenditures --** The Act repeals the reforestation tax credit and allows taxpayers to deduct up to $10,000 of reforestation costs for qualified timber property in the year paid or incurred. (**Effective Date --** The provision is effective for expenditures paid or incurred after the date of enactment.)
- **Safe Harbor Rules for Timber REITS --** The Act modifies the safe harbor rules for timber real estate investment trusts (REITs), so that the sale of real estate assets by the REIT is not a prohibited transaction under certain conditions. (**Effective Date --** The provision is effective for taxable years beginning after the date of enactment.)

Income Forecast Method of Depreciation

The Act modifies the calculation of the income forecast method of depreciation as it generally relates to motion picture, film, videotape, or sound recordings. For purposes of computing the allowable deduction for property, taxpayers may include participations and residuals in the adjusted basis of the property, beginning in the year the property is placed in service. The provision applies only if the participations and residuals relate to income to be derived from the property within 10 years after the year in which the property is placed in service.

For purposes of applying the provision, the Act defines "participations and residuals," and clarifies that the property income used when applying the income forecast method is gross income. The Act also states that the judicial decision Associated Patentees v. Commissioner, 4 T.C. 979 (1945) serves as a valid method when considering the treatment of property under the income forecast method.

Treasury and the IRS are also instructed to expeditiously resolve open cases, taking into account the principles put forth by this provision.

Effective Date -- The provision is effective for property placed in service after the date of enactment.

Business Provisions

Qualified Small Issue Bonds

Current law allows tax-exempt financing of up to $10

million to be used for certain manufacturing facilities, provided that all capital expenditures associated with the facility cannot exceed $10 million within a six-year measurement period beginning three years before the issue date of the bonds and ending three years after that date. The Act leaves the $10 million tax-exempt financing cap intact, but increases the total amount of allowable capital expenditures during the measurement period on the facility to $20 million.

Effective Date -- The provision is effective for bonds issued after September 30, 2009.

Small Business Expensing

The Act extends the section 179 expensing limit established by the Jobs and Growth Tax Relief Reconciliation Act of 2003 for two additional years, through taxable years beginning before 2008. The maximum dollar amount a qualified taxpayer may deduct for property placed in service is $100,000; the phaseout threshold is $400,000. The provision adjusts both of these limits for inflation. (Current law expires at the end of 2005, when the expensing limit would drop to $25,000, and the phaseout threshold would be reduced to $200,000.)

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

Effective Date -- The provision is effective on the date of enactment.

Film/TV Production Expenses

The Act gives taxpayers an election to deduct up to $15 million per production of qualifying film and television production expenditures in the year the expenses are incurred. This limit is increased to $20 million if a significant amount of the expenditures is incurred in low-income communities and other distressed areas. A qualified film or television production is any production of a motion picture, miniseries, scripted dramatic television episode, or movie of the week, provided that at least 75 percent of the total compensation expended for production is for services performed in the United States. With respect to property consisting of one or more episodes in a television series, only the first 44 episodes qualify for the election. Sexually explicit productions do not qualify for the deduction.

Effective Date -- The provision is effective for qualifying productions started after the date of enactment. The provision sunsets for productions beginning after December 31, 2008. For purposes of this provision, production is treated as beginning on the first date of principal photography.

Regulated Investment Company (RIC) Income

The Act modifies the 90 percent income test used by RICs to include income derived from a publicly traded partnership interest. It also modifies the lookthrough rule for partnership income of a RIC so that it applies only to income from partnerships that are not publicly traded. The limitation on ownership and the limitation on composition of assets that apply to other investments of a RIC also apply to RIC investments in publicly traded partnership interests. The current-law special rule requiring separate treatment for publicly traded partnerships under the passive loss rules will apply to a RIC holding an interest in a publicly traded partnership, for items attributable to the interest in the publicly traded partnership.

Effective Date -- The provision is effective for taxable years beginning after the date of enactment.

Real Estate Investment Trusts

The Act modifies the definition of "straight debt" that applies to a REIT's asset requirements, provides a safe harbor testing date for certain rents for purposes of the "taxable REIT subsidiary (TRS)" exception to the general rule restricting REIT securities ownership, eliminates the customary services exception related to services performed by a TRS, and modifies the 95 percent gross income requirement. The Act also allows a REIT to retain its status despite certain failures to meet REIT requirements.

Effective Date -- Generally, the provision applies retroactively to taxable years beginning after December 31, 2000. Provisions related to the customary services exception, modification of the 95 percent gross income requirement, and the new REIT status retention rules are effective for taxable years after the date of enactment.

Unrelated Business Income Limitation on Small Business Investment Company Investments

The Act modifies the definition of acquisition indebtedness under the current-law debt-financed property provisions. Generally, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. The Act excludes any indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958, which is evidenced by a debenture issued by the company under the authority of section 303(a) of the Act and held or guaranteed by the Small Business Administration.

The exclusion does not apply during periods when a nongovernmental exempt organization owns more than 25 percent of the capital and profits in the small business investment company, or when any exempt organization (including governmental units other than those of the United States) owns, in aggregate, 50 percent or more of the capital and profits of the company.

Effective Date -- The provision is effective for debt incurred after the date of enactment by small business investment companies licensed after the date of enactment.

Life Insurance Company Policyholder Surplus Accounts

The Act temporarily suspends rules that impose an income tax on a stock life insurance company when it makes direct or indirect distributions to shareholders from its policyholders surplus account. The provision also reverses the order in which distributions reduce the various accounts, so that distributions will be treated as made first out of the policyholders surplus account, then out of the shareholders surplus account, and lastly out of other accounts.

Effective Date -- The provision is effective for taxable years beginning after December 31, 2004, and before January 1, 2007.

New Markets Tax Credit Targeting

The Act authorizes Treasury to issue regulations to designate certain low-income communities as targeted populations for purposes of the New Markets Tax Credit. The Act also clarifies when a population census tract with a population of less than 2,000 can qualify as a low-income community for credit purposes.

Effective Date -- The provision is effective for designations made after the date of enactment. The provision for tracts applies to investments made after the date or enactment.

New Markets Tax Credits for High Migration Counties

The Act modifies the low-income test for census tracts within high-migration rural counties.

Effective Date -- The provision is effective as if included in the amendment made by section 121(a) of the Community Renewal Tax Relief Act of 2000.

Designated Community Renewal Areas

The Act authorizes the Secretary of Housing and Urban Development to add a contiguous census tract to a renewal community if it meets certain conditions.

Effective Date -- The provision is effective as if included in the amendments made by section 101 of the Community Renewal Act of 2000.

Occupational Taxes for Distilled Spirits

The Act suspends for three years the occupational taxes relating to distilled spirits, wine, and beer.

Effective Date -- The provision is effective on the date of enactment. The taxes are suspended from July 1, 2005, to June 30, 2008.

Tax Credit for Maintaining Railroad Tracks

The Act provides a 50 percent business tax credit for qualified railroad track maintenance expenditures. The credit is limited to $3,500 per mile of eligible railroad track owned or leased by an eligible taxpayer as of the close of its taxable year. Qualified railroad track maintenance expenditures include costs of maintaining railroad track, roadbed, bridges, and related track structures owned or leased as of January 1, 2005, by a Class II or Class III railroad. Taxpayers eligible for the credit include:

- Any Class II or Class III railroad; and
- Any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to such an individual.

The taxpayer's basis in the railroad track is reduced by the amount of railroad track tax credits received. In addition, no portion of the credit may be carried back to any taxable year beginning before January 1, 2005.

Effective Date -- The provision is effective for qualified railroad track maintenance expenditures paid or incurred during taxable years beginning after December 31, 2004, and before January 1, 2008.

Cooperative Marketing Rules (Value-Added Processing)

The Act provides that a cooperative is marketing products of members or other producers if it feeds the products of members or other producers to cattle, hogs, fish, chickens, or other animals (value-added processing) and sells the resulting animals or animal products.

This provision addresses a concern that in determining the tax-exempt status of a farmer's cooperative, the IRS had taken the position that if the cooperative added value through the use of animals, it was not marketing products of members or other producers.

Effective Date -- The provision is effective for taxable years beginning after the date of enactment.

Livestock Involuntary Conversion

The Act extends the period for replacing livestock sold on account of drought, flood, or other weather-related conditions from two years to four years. The Act also permits a taxpayer to replace involuntarily converted livestock with other farm property if the conditions that caused the conversion make it not feasible to reinvest in similar livestock.

Effective Date -- The provision is effective for any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002.

Interaction of AMT and Income Averaging by Farmers or Fishermen

The Act allows individuals engaged in the trade or business of fishing to use income averaging. It also allows benefits derived from farm or fishing income averaging to be used in computing the alternative minimum tax (AMT). Under the Act -- for purposes of computing the AMT -- a farmer's or fisherman's regular tax liability is determined as if income averaging had not been elected.

Effective Date -- The provision is effective for taxable years beginning after December 31, 2003.

S Corporations

S Corporation Reforms

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. It also provides relief for inadvertent invalid elections or terminations of an election to have a family treated as one shareholder. (**Effective Date --** The provision is effective for taxable years beginning after December 31, 2004.)
- Increase the number of permissible S corporation shareholders from 75 to 100. (**Effective Date --** 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 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. (**Effective Date --** 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. (**Effective Date --** 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. (**Effective Date --** The provision is effective for transfers after December 31, 2004.)
- Disregard unexercised powers of appointment in determining the potential current beneficiaries of an electing small business trust (ESBT). The Act also extends the period -- from 60 days to one year -- in which an ESBT can dispose of S corporation stock after an ineligible shareholder becomes a potential current beneficiary. (**Effective Date --** The provision is effective for taxable years beginning 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. (**Effective Date --** 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. (**Effective Date --** The provision is effective for taxable years beginning after December 31, 2004.)

S Corporation ESOPS

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.

Effective Date -- The provision retroactively applies to distributions made after December 31, 1997.

Energy and Fuel Tax Incentives

Credit for Electricity Produced From Certain Sources

The Act expands the credit for electricity produced from certain sources. The following new resources for electricity generation would qualify for the credit:

- **Open-Loop Biomass (Including Agricultural Livestock Waste Nutrients) --** Qualifying open-loop biomass and agricultural livestock waste facilities must be placed in service before January 1, 2006.
- **Geothermal Energy --** Qualifying geothermal energy facilities must be placed in service after the date of enactment and before January 1, 2006.
- **Solar Energy --** Qualifying solar energy facilities must be placed in service after the date of enactment and before January 1, 2006.
- **Small Irrigation Power --** Qualifying small irrigation power facilities must be placed in service after the date of enactment and before January 1, 2006.
- **Municipal Solid Waste --** Qualifying facilities producing such waste are landfill gas facilities and trash combustion facilities. These must be placed in service after the date of enactment and before January 1, 2006.
- **Refined Coal --** Qualifying refined coal facilities must be placed in service after the date of enactment and before January 1, 2009.

The Act also modifies present law to provide that:

- Qualifying closed-loop biomass facilities include any facility originally placed in service after December 31, 1992, and modified to use closed-loop biomass before January 1, 2006.
- Qualifying wind facilities include wind facilities placed in service after December 31, 1993, and before January 1, 2006.

Credit Period and Amount -- The provision, as under current law, generally allows taxpayers to claim a tax credit of 1.5 cents per kilowatt-hour (indexed for inflation and presently 1.8 cents per kilowatt-hour). Certain changes, however, are made to credit amounts and duration:

- For new facilities qualifying for the credit (except for refined coal), the credit is only available for five years. In addition, the otherwise allowable credit amount is reduced by half for open-loop biomass facilities (including agricultural livestock waste nutrients), small irrigation power, landfill gas facilities, and trash combustion facilities.
- For facilities placed in service before January 1, 2005, the credit period begins on January 1, 2005. The credit period for closed loop-biomass facilities modified to co-fire with coal, other biomass, or coal and other biomass, does not begin earlier than the date of enactment.

Qualified refined clean coal facilities may claim a credit of $4.375 per ton (indexed for inflation) of refined coal sent to an unrelated person.

Effective Date -- The provision is effective for electricity produced and sold from qualifying facilities after the date of enactment in taxable years ending after the date of enactment. With respect to open-loop biomass facilities placed in service before January 1, 2005, the provisions are effective for electricity produced and sold after December 31, 2004.

Dispositions of Transmission Property to Implement Federal Energy Regulatory Commission Restructuring Policy

The Act permits a taxpayer to elect to recognize gain from a qualifying electric transmission transaction ratably over an eight-year period beginning in the year of sale, if the amount realized from the sale is used to purchase exempt utility property within an applicable period (that is, four years after the close of the taxable year in which the qualifying electric transmission transaction occurs). Under the provision, a qualifying electric transmission sale or disposition to an independent transmission company must occur prior to January 1, 2007. If a taxpayer is a member of an affiliated group filing a consolidated return, the provision allows the reinvestment property to be purchased by any member of the group. A taxpayer making an election is required to attach a statement regarding the election in the tax return for

the taxable year in which the transaction takes place. Finally, the election is binding for that taxable year and all subsequent years.

Effective Date -- The provision is effective for transactions occurring after the date of enactment, in taxable years ending after such date.

Business Energy Credits Allowed Against AMT

The Act allows taxpayers to use the following business energy credits against the AMT:

- The alcohol fuels credit (for tax years beginning after December 31, 2004); and
- The credit for electricity produced (1) at facilities placed in service after the date of enactment, and (2) during the first four years of production beginning on the date the facility is placed in service.

Effective Date -- The provision is effective for taxable years ending after the date of enactment.

Marginal Well Production Tax Credit

The Act creates a new $3-per-barrel credit for the production of crude oil and a 50-cent credit per 1,000 cubic feet of qualified natural gas production. The credit is not available to production that occurs when the reference price of oil exceeds $18 ($2 for natural gas). The credit is reduced proportionately as the reference price ranges between $15 and $18 ($1.67 and $2 for natural gas). Unused credits can be carried back for up to five years.

Effective Date -- The credit is available for production in taxable years that start after December 31, 2004.

Electric Co-op 85/15 Rule Change

The Act allows tax-exempt cooperatives to receive income from nonmembers and to participate in open access transactions without losing their tax-exempt status. In particular, it provides that certain income from open access transactions is excluded in determining whether a rural electric cooperative satisfies the 85 percent test for tax exemption under section 501(c)(12). It also provides that certain income from nuclear decommissioning transactions, the voluntary exchange or involuntary conversion of property, sale of electric energy distribution services or ancillary services, and load loss transactions are excluded from the 85 percent test.

Effective Date -- The rule change applies to taxable years beginning after the date of enactment and before January 1, 2007.

Modification to the Small Producer Ethanol Credit

Under the Act, a cooperative may elect to pass through the small ethanol producer credit to its patrons. The credit is to be apportioned among patrons eligible to share in patronage dividends based on the quantity or value of business done with, or for, those patrons during the taxable year.

Distributed credits are to be included in the patron's credit for the first taxable year of each patron ending on or after the last day of the payment period for the organization's taxable year, or, if earlier, for the taxable year of each patron ending on or after the date on which the patron receives notice regarding the credit.

Credits not apportioned to patrons are included in the organization's credit for the taxable year. If the amount of the credit shown on the cooperative's tax return exceeds the actual amount of the credit for a given year, the excess is treated as an increase in the cooperative's tax. Once made, elections are irrevocable for a given tax year.

Effective Date -- The provision is effective for taxable years ending after the date of enactment.

Expensing Capital Costs Incurred Complying With EPA Sulfur Regulations

The Act permits small business refiners to claim an immediate deduction for up to 75 percent of the costs paid or incurred when complying with Environmental Protection Agency (EPA) sulfur control regulations. For purposes of the provision, a small business refiner is one who employs fewer than 1,500 employees and has less than 205,000 barrels a day of total refinery capacity.

Effective Date -- This provision is effective for expenses paid or incurred after December 31, 2002, in taxable years ending after such date.

Small Refiners Diesel Fuel Production Credit for EPA Sulfur Compliance

The Act provides a credit to small business refiners equal to five cents per gallon for each gallon of low-sulfur diesel fuel produced during the taxable year that complies with EPA sulfur requirements. The total production credit claimed by a taxpayer cannot exceed 25 percent of the capital costs incurred to comply with the EPA's diesel fuel requirements. For purposes of this provision, a small business refiner is one that employs fewer than 1,500 employees and has less than 205,000

barrels a day of total refinery capacity.

Effective Date -- The provision is effective for expenses paid or incurred after December 31, 2002.

Volumetric Ethanol Excise Tax Credit

The Act replaces the present-law reduced excise tax rates for most alcohol-blended fuels with two new excise tax credits: the alcohol fuel mixture credit and the biodiesel mixture credit. The alcohol fuel mixture excise tax credit is 51 cents per gallon of alcohol used by the taxpayer to produce an alcohol fuel mixture for sale or use in a trade or business. If the alcohol fuel mixture does not contain ethanol, the credit is 60 cents.

The biodiesel mixture excise tax credit is 50 cents per gallon used to produce a qualified biodiesel fuel mixture for sale or use in a trade or business. The credit increases to $1 for each gallon of agri-biodiesel that is produced.

Producers and importers of biodiesel or alcohol are required to register with Treasury.

The Act extends the present-law alcohol fuels income tax credit to December 31, 2010, and repeals the general fund retention of certain alcohol fuel taxes as of September 30, 2004.

Effective Date -- The provisions are effective for fuel sold or used after December 31, 2004. The alcohol mixture credit expires December 31, 2010; the biodiesel mixture credit expires December 31, 2006. The reporting requirements take effect on January 1, 2005. The registration requirement takes effect on April 1, 2005.

Biodiesel Income Tax Credit

The Act provides a new biodiesel fuels credit that is the sum of two credits: one for biodiesel and one for biodiesel mixture. Taxpayers may claim a credit of 50 cents for each gallon of biodiesel used in the production of a qualified biodiesel mixture that is sold or used in a trade or business. Taxpayers may also claim a 50 cents-per-gallon biodiesel credit for each gallon of biodiesel that is not in a mixture with diesel fuel. If the biodiesel is agri-biodiesel the credit would be increased to $1.

Effective Date -- The credit is effective for fuel sold or used after December 31, 2004, and before January 1, 2007.

Exclusion of Gain or Loss for Sale or Exchange of Certain Brownfield Sites From UBTI

The Act excludes the gain or loss from the sale or exchange of a qualifying brownfield property from unrelated business taxable income, even if the property is stock in trade or inventory to the seller. Acquisition financing of a qualifying brownfield property will not cause the property to be debt-financed property.

Effective Date -- The provision applies to gain or loss on the sale, exchange, or other disposition of property acquired by the taxpayer during the period beginning January 1, 2005, and ending December 31, 2009.

Alaskan Natural Gas Pipelines and Processing Plants

The Act includes two provisions relating to Alaskan natural gas:

- **Recovery Period for Pipelines --** Under the Act, Alaskan natural gas pipelines are subject to a seven-year recovery period and a class life of 22 years. To qualify, property must be placed in service after December 31, 2013, or treated as placed in service on January 1, 2014, although a taxpayer can elect to treat property placed in service before that date as post-2013 property. (**Effective Date --** The provision is effective for property placed in service after December 31, 2004.)
- **Construction of Processing Plants --** Expenses related to the construction of any qualifying natural gas processing plant capable of processing 2 trillion British thermal units of natural gas a day into a natural gas pipeline system are qualified enhanced oil recovery costs eligible for the enhanced oil recovery credit. The qualifying plant must also produce carbon dioxide for re-injection into a producing oil or gas field. (**Effective Date --** The proposal is effective for costs paid or incurred in taxable years beginning after December 31, 2004.)

Tax Incentives for Individuals

Deduction for State and Local Sales Taxes

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. 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.

Effective Date -- The provision is effective for taxable years beginning after December 31, 2003, and before January 1, 2006.

Civil Rights Tax Relief

The Act provides an above-the-line deduction for attorney fees and court costs associated with an unlawful discrimination suit.

Effective Date -- The provision is effective for costs paid after the date of enactment with respect to any judgments or settlements occurring after such date.

Dividend Allocation Rule

The Act establishes a special rule to allow cooperatives to pay dividends on capital stock without those dividends reducing excludable patronage income to the extent that the cooperative's articles of incorporation or bylaws direct that dividends do not reduce amounts owed to patrons.

Effective Date -- The provision is effective for taxable years beginning after the date of enactment.

Rural Letter Carriers

The Act permits rural letter carriers to claim a miscellaneous itemized deduction for unreimbursed expenses incurred for using a vehicle to perform services.

Effective Date -- The provision is effective for taxable years beginning after December 31, 2003.

Charitable Deduction for Support of Alaskan Subsistence Whaling

This provision allows individuals who are designated as whaling captains by the Alaska Whaling Commission to deduct as a charitable contribution up to $10,000 per year of reasonable and necessary expenses incurred to carry out sanctioned whaling activities.

Effective Date -- This provision applies to contributions made after December 31, 2004.

National Health Service Corps Loan Repayment

The Act excludes from gross income and employment taxes education loan repayments provided under the National Health Service Corps Loan Repayment Program and state programs eligible for funds under the Public Health Service Act. In addition, these repayments are not taken into account as wages in determining benefits under the Social Security Act.

Effective Date -- The provision applies to amounts received in taxable years beginning after December 31, 2003.

Chapter 7:

Other Revenue Raisers

Business-Related Revenue Raisers

Consistent Amortization Periods for Intangibles

The Act allows taxpayers to elect to deduct up to $5,000 of start-up and $5,000 of organizational expenditures in the tax year in which a trade or business begins. Each $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins are amortized over 15 years, consistent with the amortization period for section 197 intangible assets.

Effective Date -- This provision is effective for start-up and organizational expenditures paid or incurred after the date of enactment.

Acquisitions of Sports Franchises

The Act extends the 15-year recovery period for intangible assets to sports franchises and any intangible asset acquired in connection with the acquisition of such a franchise (for example, player contracts).

The measure also repeals other special rules for sports franchises relating to: (1) the basis limitation for player contracts; (2) the recapture of ordinary income on the disposition of player contracts; and (3) the exception for sports franchises from the general rules of section 1253 relating to transfers of franchises, trademarks, and trade names.

Effective Date -- The provision is effective for acquisitions occurring after the date of enactment.

Straddle Rules

The Act modifies current-law straddle rules to: (1) permit taxpayers to identify offsetting positions of a straddle; (2) provide a special rule for certain physically settled positions of a straddle; and (3) repeal the stock exception from the straddle rules.

Effective Date -- The provision is effective for positions established on or after the date of enactment.

Observation

Because Congress believes that Treasury is not using its authority under current law to issue guidance regarding unbalanced straddles, the Act explicitly gives Treasury statutory authority to issue guidance in this area.

Cancellation of Indebtedness Income for Partnerships

The Act provides that, when a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership generally recognizes cancellation of indebtedness (COD) income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest. The provision applies regardless of whether the debt is recourse or nonrecourse. Any COD income is allocated solely among partners holding an interest in the partnership immediately before the satisfaction of the debt.

Effective Date -- The provision is effective for cancellations of indebtedness on or after the date of enactment.

Treatment of Stripped Interests in Bond and Preferred Stock Funds

The Act authorizes the Treasury Department to publish regulations governing the treatment of direct or indirect interests in bond and preferred stock funds that are similar to current rules governing the treatment of stripped bonds and stripped preferred stock. The provision applies only in cases in which the current-law rules for stripped bonds and stripped preferred stock are not already applicable.

Effective Date -- The provision is effective for purchases and dispositions occurring after the date of enactment.

Readily Tradable Debt

The Act denies installment sale treatment for sales in which the seller receives readily tradable debt.

Effective Date -- The provision is effective for sales occurring on or after the date of enactment.

Treatment of Transfers to Creditors in a Divisive Reorganization

The Act limits the amount of boot received from a controlled corporation that a distributing corporation can distribute to creditors, without gain recognition in connection with a transaction otherwise qualifying under section 355, to the basis of assets transferred to the controlled corporation in the divisive reorganization. Acquisitive D reorganizations (those reorganizations described in section 368(a)(1)(D) not occurring in connection with a section 355 transaction) are exempted from the rule under section 357(c) that requires gain to be recognized to the extent that liabilities assumed exceed the basis of assets transferred.

This provision will impose limitations on the amount of leverage that can be used in a spin-off.

Effective Date -- The provision is effective for transactions on or after the date of enactment.

Estimated Tax for Deemed Asset Sales

The Act clarifies rules for payment of estimated tax attributable to certain deemed asset sales. Under current law, section 338(h)(13) provides that tax on deemed asset sales as a result of elections under sections 338(g) or 338(h)(10) is not taken into account for estimated tax purposes. Elections under both these sections must be made by the fifteenth day of the ninth month following the qualified stock purchase.

Whereas an election under section 338(g) is made unilaterally by the buyer (in which gain is recognized both by the seller on the sale of the stock and by the buyer on the deemed asset sale), an election under section 338(h)(10) is made by both the buyer and the seller, and results in tax currently payable only by the seller. Because the decision to make the election is typically made before the transaction is finalized, the Act provides that the exception in section 338(h)(13) does not apply to deemed asset sales elected under section 338(h)(10). Estimated tax for qualified stock purchases eligible for the election under section 38(h)(10) should be determined as if the transaction were a stock sale until the parties agree to make the election. At that point, the estimated tax must be calculated as if the transaction were an asset sale. If the agreement to make the election occurs after the transaction closes, estimated tax must be recomputed based on the asset sale election.

Existing law under section 338(h)(13) remains unchanged with respect to section 338(g) elections.

Effective Date -- The provision is effective for transactions occurring after the date of enactment.

Definition of Controlled Group

The Act modifies the definition of a controlled group of corporations to provide that a brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates, or trusts own (or constructively own) more than 50 percent of the total voting power or value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation.

The provision applies only for purposes of section 1561 (currently relating to corporate tax brackets) the accumulated earnings credit, and the minimum tax. It does not affect other Internal Revenue Code sections or other provisions that refer to the section 1563 brother-sister corporation controlled group test for other purposes. For those purposes, the existing definition of a brother-sister controlled group remains in effect.

Effective Date -- The provision is effective for taxable years beginning after date of enactment.

Limitation on Depreciation of Sport Utility Vehicles

The Act lowers the maximum depreciation deduction for sport utility vehicles (SUVs) to $25,000 (from $100,000). Pickup trucks and delivery vans are excluded from the definition of SUV, as are large passenger vehicles that hold more than nine passengers behind the driver's seat.

Effective Date -- The provision applies to property placed in service after the date of enactment.

Observation

Small businesses and self-employed individuals are likely to be hardest hit by this provision.

Specific Class Lives for Utility Grading Costs

The Act assigns class lives to depreciable electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines. The Act includes these assets in the property classes to which the clearing and grading costs relate, giving these assets a recovery period of 20 years and 15 years, respectively.

Effective Date -- The provision is effective for property placed in service after the date of enactment.

Suspension of Customs Duties

The Act suspends the following Customs duties:

- The 4.7 percent ad valorem duty on imported ceiling fans from all sources (through December 31, 2006); and
- The 3.3 percent duty applicable to nuclear reactor vessel heads and pressurizers for column 1 countries (through December 31, 2008);

In addition, the Act extends the present-law suspension of Customs duties applicable to nuclear steam generators through December 31, 2008. Under current law, nuclear steam generators may enter the United States duty free through December 31, 2006.

Effective Date -- The suspension of duties on ceiling fans and nuclear reactor vessel heads and pressurizers is effective on the fifteenth day after the date of enactment. The provision extending the suspension of duties on nuclear steam generators is effective on the date of enactment.

Individual Tax Provisions

Sale of Principal Residence

The Act provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the residence was acquired in a like-kind exchange within the prior five years.

Effective Date -- This provision applies to sales or exchanges after the date of enactment.

Capital Gain Treatment of Sales of Stock Acquired From Exercise of Statutory Stock Options to Comply With Conflict-of-Interest Requirements

The Act provides that an eligible person who, in order to comply with federal conflict-of-interest requirements, sells shares of stock acquired pursuant to the exercise of a statutory stock option will be treated as satisfying the statutory holding period requirements for capital gains treatment, regardless of how long the stock was actually held. An eligible person generally includes an officer or employee of the executive branch of the federal government (and any spouse or minor or dependent children whose ownership in property is attributable to the officer or employee). The employer granting the option is not allowed a deduction upon the sale of the stock by the individual.

Effective Date -- The provision is effective for sales after the date of enactment.

Chapter 8:

Excise Tax and Related Provisions

Revenue Raising Provisions

Aviation Jet Fuel

The Act provides that aviation fuel is taxed when it is removed from a refinery or terminal or when it enters into the United States, rather than when it is sold. Generally, the full rate of tax -- 21.9 cents per gallon -- is imposed when the fuel is removed from a refinery or terminal or when it enters the United States. However, fuel may be removed at a reduced rate -- 4.4 cents per gallon or at no charge -- if it is:

- Removed directly into the wing of an aircraft that is registered as a buyer of aviation fuel for use in commercial aviation, a foreign airline entitled to the present-law exemption for aviation fuel used in foreign trade, or for a tax-exempt use; or
- Removed or entered as part of an exempt bulk transfer.

A special rule treats certain refueling trucks, tankers, and tank wagons as a terminal under certain conditions. Although the provision does not change tax rates applicable under current law, it does impose liability for the tax on aviation fuel removed from a refinery or terminal directly into the wing of an aircraft for use in commercial aviation on the person receiving the fuel.

The Act provides that the ultimate vendor of aviation fuel may receive a refund for fuel taxes if the vendor sells fuel for which tax has been paid to a person qualified to purchase the fuel, at a reduced tax rate, who has waived the right to a refund.

Finally, a floor stocks tax applies to aviation jet fuel held by a person on January 1, 2005. The tax is equal to the amount of tax that would have been imposed before January 1, 2004, if the measure was in effect at all times before that date. However, the tax is reduced by: the tax imposed by section 4091 (as in effect on the day before such date) and, in the case of kerosene held exclusively for the holder's own use, the amount that the holder would reasonably expect under the proposal to be paid as a refund for nontaxable use.

Effective Date -- The provision is effective for aviation fuel that is removed from a terminal, enters into the United States, or is sold after December 31, 2004.

Mobile Machinery

The Act codifies the present-law mobile machinery exemption for purposes of the retail tax on heavy vehicles, the heavy vehicle use tax, and the tax on tires. The vehicle exception applies if a three-part design test is met: (1) the vehicle consists of a chassis to which job site machinery has been permanently mounted; (2) the chassis has been specially designed to serve only as a mobile carriage and mount for the particular machinery; and (3) because of that special design, the chassis could not be used to transport a load other than the particular machinery without substantial structural modification.

For purposes of the fuel excise tax, the Act codifies the three-part design test and adds a use test, which requires that the vehicle must not travel more than 7,500 miles over public highways during a taxable year. The Act also provides that refunds of fuel taxes are permitted only on an annual basis, and that vehicles owned by a section 501(c) organization need only satisfy the three-part design test to recover taxes paid with respect to mobile machinery vehicles.

Effective Date -- The proposal is generally effective on the day after the date of enactment. As to the fuel taxes, the proposal is effective for taxable years beginning after the date of enactment.

Modified Definition of Off-Highway Vehicle

The Act adopts the definitions of an off-highway transportation vehicle and a nontransportation trailer and semi-trailer described in proposed Treasury regulations.

Under the Act, a vehicle is not a highway vehicle if:

- It is specially designed for the primary function of transporting a particular type of load over a public highway; and
- Because of this special design, its capability to transport the load over the highway is substantially limited or impaired.

A vehicle's design is determined solely on the basis of its physical characteristics. Factors to be considered in determining whether there is a substantial limitation or impairment include: (1) the size of the vehicle; (2) whether it is subject to the licensing, safety, and other requirements applicable to highway vehicles; and (3) whether it can transport a load at a sustained speed of at least 25 miles per hour.

The Act includes an exception to the definition of a highway vehicle for nontransportation trailers and semi-trailers. These vehicles are not highway vehicles if they are specially designed to function only as an enclosed stationary shelter to carry out an off-highway function at an off-highway site.

Effective Date -- The provision is generally effective on the date of enactment. As to the fuel taxes, the proposal is effective for taxable periods beginning after the date of enactment.

Modification of the Use Tax on Heavy Vehicles

The Act modifies the use tax on heavy vehicles to:

- Eliminate the option to pay the tax in installments;
- Eliminate reduced rates for Canadian and Mexican vehicles;
- Require taxpayers with 25 or more vehicles for any taxable period to file returns electronically; and
- Permit the proration of tax for vehicles sold during the taxable period.

Effective Date -- The provision is effective for taxable periods beginning after the date of enactment.

Heavy Truck Tire Tax

The Act simplifies the excise tax applicable to heavy truck tires by replacing the present-law tax rates (which are based on the weight of tires) with a tax rate based on the load capacity of tires. The tax would generally be 9.45 cents for each 10 pounds of tire load capacity over 3,500 pounds. For bias-ply tires or super single tires, the tax rate would be 4.725 cents for each 10 pounds of tire load capacity over 3,500 pounds.

This provision also modifies the definition of tires for use on highway vehicles to include any tire marked for highway use under Transportation Department regulations. Any tire sold for the exclusive use of the Department of Defense or the Coast Guard would be exempt from tax.

Effective Date -- The provision is effective for sales in calendar years beginning more than 30 days after the date of enactment.

Repeal of Certain Excise Taxes on Rail Diesel and Inland Waterway Fuels

The Act phases out the 4.3 cents-per-gallon excise tax rates on diesel fuel used in trains and barges operating in inland waterway systems. The provision reduces the 4.3 cents-per-gallon excise tax by one cent per gallon for the period January 1 through June 30, 2005, and two cents per gallon for the period July 1, 2005, through December 31, 2006. It is fully phased out beginning January 1, 2007.

Effective Date -- The provision is effective on January 1, 2005.

Taxable Vaccines

The Act adds vaccines against hepatitis A and influenza to the list of taxable vaccines. Vaccines on the taxable list, which covers immunizations given to children, carry a manufacturer's excise tax of 75 cents per dosage.

Effective Date -- The provision regarding hepatitis A is effective for vaccine sales and uses after the first day of the first month beginning more than four weeks after the date of enactment. The provision affecting influenza is effective for vaccines sold or used beginning on the later of the first day of the first month beginning more than four weeks after the date of enactment, or the date on which the Secretary of Health and Human Services lists any vaccine against influenza for purposes of compensation for any vaccine-related injury or death through the Vaccine Injury Compensation Trust Fund.

Archery Products

The Act modifies current-law excise taxes on imported archery products. Specifically, the provision increases the draw weight for a taxable bow from 10 pounds or more to a peak draw weight of 30 pounds or more. It also imposes a 12 percent excise tax on arrows generally, and subjects certain broadhead arrow points to an excise tax equal to 11 percent of the sales price. The current-law 12.4 percent excise tax applicable to certain arrow components (excluding broadheads) remains unchanged.

Effective Date -- The provision is effective for articles sold by the manufacturer, producer, or importer 30 days after the date of enactment.

Tax Cuts

Excise Tax on Fishing Tackle Boxes

The excise tax on fishing tackle boxes is reduced to 3 percent (from 10 percent).

Effective Date -- This provision applies to articles sold by a manufacturer, producer, or importer after December 31, 2004.

Repeal of Excise Tax on Sonar Devices for Finding Fish

The Act repeals the excise tax on sonar devices suitable for finding fish.

Effective Date -- The provision applies to articles sold by a manufacturer, producer, or importer after December 31, 2004.

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