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TAX & TRANSACTIONS BULLETIN

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- On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 ("Act").
- The Act's main purpose is to repeal the extraterritorial income exclusion (ETI).
- To compensate U.S. manufacturers for loss of ETI, the Act creates a new manufacturing deduction. New Code Section 199 creates this deduction based on the "qualified production activities income" of U.S. taxpayers. This new manufacturing deduction replaces the tax benefits lost due to repeal of ETI. The new deduction generally provides tax relief equivalent to a 3% reduction in taxes on U.S. based manufacturing.
- The Act also provides broad tax relief for individuals and businesses.
- Companion legislation known as the "Working Families Tax Relief Act of 2004," signed by President Bush on October 4, 2004, provides alternative minimum tax (AMT) relief.

SUMMARY OF "AMERICAN JOBS CREATION ACT OF 2004" ("ACT"), SIGNED BY PRESIDENT GEORGE W. BUSH ON OCTOBER 22, 2004

On October 22 President Bush signed the American Jobs Creation Act of 2004 ("Act"). The Act provides broad tax cuts for individuals and businesses. The Act also repeals the extraterritorial income exclusion (ETI), following a ruling by the World Trade Organization that ETI provided an illegal tax-subsidy for U.S. exporters. To compensate U.S. manufacturers for loss of this subsidy, the Act creates a new manufacturing deduction. Related legislation known as the "Working Families Tax Relief Act of 2004," signed by President Bush on October 4, provides alternative minimum tax (AMT) relief.

INDIVIDUALS

1. Deduction of State and Local General Sales Taxes

The Act permits individuals who itemize their deductions to elect to deduct either state and local income taxes or state and local general sales taxes for 2004 and 2005. The sales tax deduction is equal to either (1) actual sales tax paid based on retained receipts, or (2) an amount based on IRS Tables. Individuals living in the 7 States with no personal income tax will especially benefit. Thus, individuals living in Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming should benefit from this new sales tax deduction. Individuals living in the remaining 43 States and the District of Columbia will want to compare their sales tax to their income tax, and then deduct the larger.[1]

2. 5 Year Ownership Required to Exclude Gain on Sale of Principal Residence Acquired in Like-Kind Exchange

Generally for an individual to exclude gain ($250,000 for single taxpayers, $500,000 for married couples filing jointly) on the sale of her home, she must have owned and used that property as a Principal Residence for at least 2 years during the prior 5-year period. However, the Act provides that where a Principal Residence is acquired in a like-kind exchange after October 22,

[1]Purchase of a luxury item (e.g. new car or boat) may favor deducting sales tax. Note that individuals cannot deduct sales tax for alternative minimum tax (AMT) purposes. Individuals also cannot deduct state income taxes and state property taxes for AMT purposes.

2004, the individual must own that Principal Residence for at least 5 years prior to its sale to exclude the gain. The new 5-year ownership rule addresses "tax shelter concerns" which arise where an individual converts business or investment property acquired in a like-kind exchange into a Principal Residence.[2]

3. Above-The-Line Deduction for Attorney Fees and Court Costs Incurred in Civil Rights Lawsuits

The Act creates a new above-the-line deduction for attorney fees and court costs incurred by an individual in Civil Rights Lawsuits. Specifically, the new deduction applies to attorney fees and court costs in connection with a lawsuit involving (1) a claim of unlawful discrimination, (2) certain claims against the U.S. Government, and (3) a private cause of action under the Medicare Secondary Payer Statute. The new deduction cannot exceed the amount includable in the individual's gross income due to a judgment or settlement of the lawsuit. As an "above-the-line" deduction, these attorney fees and court costs will not be reduced on Schedule A, and will not be disallowed for AMT purposes.[3]

BUSINESS DEDUCTIONS

1. Section 179 Expense of $100,000 for Tangible Business Property and "Off-the-Shelf" Computer Software

The Act extends through 2007 the favorable $100,000 deduction for purchases of tangible business assets and off-the-shelf computer software.[4] Thus, the Act ensures that for tax years 2003-2007, the favorable Section 179 deduction is $100,000. The $100,000 limit is adjusted for inflation beginning in 2004 ($102,000 in 2004). The $400,000 investment limitation is also extended through 2007, and is adjusted for inflation beginning in 2004 ($410,000 in 2004). Beginning in 2008, the Section 179 deduction returns to $25,000, and the investment limitation returns to $200,000.

2. Maximum Section 179 Expense of $25,000 for Heavy SUVs

The Act limits the cost of a heavy[5] SUV which may be expensed under Section 179 to $25,000 for vehicles placed in service after October 22, 2004.[6]

[2] The new 5-year ownership rule only applies to homes acquired in a like-kind exchange. Also, the 2-year use rule remains unchanged. Thus, the new law merely delays the $250,000 / $500,000 exclusion where a home is acquired in a like-kind exchange.

[3] The new deduction partially resolves a split among U.S. Courts of Appeals on whether contingent fees paid to an attorney are taxable income to the plaintiff. In Circuits holding that the fees are taxable income to the plaintiff, the prior "below-the-line" deduction was effectively inadequate, which could result in a situation where a plaintiff might owe more in income tax than the amount she actually recovers.

[4] Without the Section 179 deduction, these types of property would have to be depreciated and thus cost-recovery would require several years.

[5] "Heavy" means a truck, van, or SUV built on a truck chassis with a gross vehicle weight rating (i.e. maximum loaded weight) in excess of 6000 lbs.

[6] A taxpayer may still purchase a heavy pick-up truck or van and expense the entire cost (assuming 100% business use).

3. 15 Year Depreciation Period for Qualified Leasehold Improvements

The Act provides that a lessor or lessee may depreciate a Qualified Leasehold Improvement[7] over 15 years using the straight-line method. The property must be placed in service after October 22, 2004, and before January 1, 2006. Favorable 15-year depreciation only applies to leasehold improvements made to buildings more than 3 years old. This special 15-year depreciation period has substantial tax benefits over the general 39-year recovery period for leasehold improvements.[8]

4. 15 Year Depreciation Period for Improvements to Restaurant Buildings

The Act provides a 15-year depreciation period for Qualified Restaurant Property[9] placed in service after October 22, 2004, and before January 1, 2006. The straight-line method applies. Favorable 15-year depreciation only applies to improvements made to restaurant buildings more than 3 years old.

S CORPORATIONS

1. S Corporation Shareholder Limit Increased to 100

Effective for tax years beginning after December 31, 2004, the maximum number of eligible S corporation shareholders is increased from 75 to 100.

2. S Corporation Family Members Treated as One Shareholder

In determining the 100-shareholder limit, all family members may elect to be treated as one shareholder. "Family Members" includes a common ancestor, lineal descendants of that common ancestor, and the spouses (or former spouses) of the lineal descendants or the common ancestor.[10]

[7] Qualified Leasehold Improvement property is any improvement to an interior portion of nonresidential real property if the following requirements are satisfied: (1) The improvement is made under or pursuant to a lease by the lessee, any sublessee, or the lessor (a commitment to enter into a lease is treated as a lease for this purpose); (2) the lease is not between related persons; (3) the building (or portion that the improvement is made to) is occupied exclusively by the lessee or sublessee; (4) the improvement is section 1250 property (i.e., a structural component); and (5) the improvement is placed into service more than 3 years after the date that the building was first placed into service. (Code Sec. 168(k)(3); Temporary Reg. §1.168(k)-1T(c)). Note that improvements to residential rental property do not quality. The building must be nonresidential real property (i.e. section 1250 property with a class life of 17.5 years or greater that is not residential rental property, such as an office building, retail store, or industrial building).

[8] Expenditures for the following are not Qualified Leasehold Improvement property: (1) the enlargement of the building; (2) elevators and escalators; (3) structural components that benefit a common area; and (4) internal structural framework. The term "common area" generally refers to areas used by different lessees of a building, such as stairways, hallways, lobbies, common seating areas, interior and exterior pedestrian walkways and pedestrian bridge, loading docks and areas, and rest rooms.

[9] Qualified Restaurant Property is any section 1250 property which is an improvement to a building if the improvement is placed in service more than 3 years after the date the building was first placed in service and more than 50 percent of the building's square footage is devoted to preparation of and seating for on-premises consumption of prepared meals (Code Sec. 168(e)(7), as added by the 2004 Jobs Act).
Note that fast-food restaurants with limited seating space should be able to qualify since the meal preparation area is taken into account in determining the more-than-50-percent test. The IRS issued an "Industry Directive" dated December 8, 2003, which contains a detailed chart that categorizes various original restaurant components as section 1250 property (depreciable over 39 years). Items listed in this chart as section 1250 property and placed in service after the effective date and before January 1, 2006, as an improvement to an existing restaurant building (but more than 3 years after the building was originally placed in service) should qualify for 15-year depreciation under the new law.

[10] The common ancestor generally cannot be more than 6 generations removed from the youngest shareholder.

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3. Transfer of Suspended Losses to a Spouse or Former Spouse Incident to Divorce

If a shareholder transfers his stock to his 1) spouse, or 2) former spouse incident to divorce, any suspended S Corporation losses with respect to that stock will carryover to the transferee.[11]

CHARITABLE GIFTS

1. Gifts of Motor Vehicles, Boats and Aircraft

Beginning January 1, 2005, for charitable donations of used motor vehicles, boats and aircraft with a claimed value in excess of $500, no charitable deduction is available unless the taxpayer obtains a "Contemporaneous Written Acknowledgement"[12] from the charitable organization.

2. Additional Reporting Required for Non-Cash Charitable Gifts

Effective for charitable gifts made after June 3, 2004, the reporting requirements for non-cash charitable donations have been increased. For property valued at more than $500, the taxpayer must include with the return a written description of the donated property and any additional information as required by IRS. For property valued at more than $5,000, the taxpayer must obtain a qualified appraisal, maintain records, and include with the return an appraisal summary and any additional information as required by IRS.

3. Deduction for Charitable Gifts of Patents or Other Intellectual Property is Limited to Lesser of Cost Basis or Fair Market Value

Effective for charitable gifts made after June 3, 2004, the deduction for a gift of patents, certain copyrights, trademarks, trade names, trade secrets, know-how, certain software, or similar intellectual property is limited to the lesser of the taxpayer's basis or the property's fair market value.[13]

COMPENSATION

1. New Code Section 409A for Nonqualified Deferred Compensation Plans

Effective for amounts deferred on or after January 1, 2005,[14] deferred compensation which is not subject to a substantial risk of forfeiture[15] is currently included in income unless the requirements of new Code Section 409A are satisfied.[16] The new law is designed to prevent early withdrawals by executives. There are

[11] This new carryover is an exception to the general rule that S Corporation suspended losses disappear when a shareholder transfers all of his stock to another person.

[12] The Contemporaneous Written Acknowledgement must include detailed information and be attached to the taxpayer's return.

[13] A donor-taxpayer is allowed an additional deduction (in the year of the gift and in later years) for a percentage of the income received by the charity from the intellectual property.

[14] Amounts deferred prior to January 1, 2005, are exempt from the new law if: (1) these amounts are fully vested prior to January 1, 2005; and (2) there is no material modification to the deferral arrangement after October 3, 2004.

[15] "Substantial risk of forfeiture" means that the individual's right to the deferred compensation is conditioned on the future performance of substantial services. ["Vested" means that the individual's right to the deferred compensation is nonforfeitable.]

[16] Code Section 409A generally imposes the following requirements: (1) restrictions on when a participant can make an initial deferral election; (2) restrictions on the earliest date a participant may receive distributions; (3) prohibition against acceleration of distributions; (4) restrictions on a participant's ability to make a subsequent election which delays the time of a distribution (or alters its form); and (5) immediate taxation of offshore Rabbi Trusts, and immediate taxation of Plans which provide for funding or increased security of deferred-compensation assets triggered by changes in the employer's financial condition.

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substantial taxes and penalties on individuals who fail to comply. Employers and participants should immediately review all deferred compensation arrangements.[17]

2. No Employment Tax and No Withholding for Qualified Stock Options

Employment taxes[18] and income-tax withholding do not apply to compensation income[19] from incentive stock options (ISOs) or employer stock purchase plans (ESPPs). This income, however, must be reported on Form W-2 and remains subject to income taxation. Qualifying capital gains (non-compensation income) is not reported on Form W-2.

WORKING FAMILIES TAX RELIEF ACT OF 2004, SIGNED BY PRESIDENT BUSH ON OCTOBER 4, 2004

1. One-Year Extension of AMT Relief for Individuals

For tax years beginning in 2003, 2004 or 2005:

A. The AMT exemption for an individual taxpayer is $58,000 in the case of a joint return filer or a surviving spouse.

B. The AMT exemption is $40,250 for an individual who is not married and who is not a surviving spouse.

C. The AMT exemption is $29,000 for an individual who is married but files a separate return.

The AMT exemption remains at $22,500 in the case of an estate or trust.

ILLINOIS PARTNERSHIP TAX RELIEF

For taxable years ending on or after December 31, 2004, "investment partnerships"[20] are no longer subject to the 1.5% Illinois Replacement Tax.

[17]Section 409A does not apply to: (1) qualified plans (including 401(a) plans, 403(a) qualified annuity plans, 403(b) annuity contracts, 408(k) simplified employee pensions, 408(p) SIMPLE retirement accounts, 457(b) eligible plans of state or local governments or tax-exempt organizations, and 415(m) qualified governmental excess benefit arrangements); or (2) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

[18]"Employment taxes" refers to FICA, FUTA, and Railroad Retirement Act taxes.

[19]There is no employment tax and no withholding obligation for both (1) exercise of an ISO or ESPP option, and (2) a subsequent sale of stock acquired by that exercise.

[20]35 ILCS 5/1501(a) (11.5). An "investment partnership" is any entity treated as a partnership for federal income tax purposes which meets the following requirements: (1) at least 90% of the partnership's total assets consist of investment securities, bank deposits, and office space and equipment necessary to carry on its investment activities; (2) at least 90% of the partnership's gross income consists of interest, dividends, and gains from the sale of investment securities; and (3) the partnership is not a dealer.

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