KEY PROVISIONS IN THE AMERICAN JOBS CREATION ACT OF 2004

The "American Jobs Creation Act of 2004" (the Act) was signed on October 22 2004, after months of debate on how to proceed with this legislation to repeal the exclusion for extraterritorial income, which the World Trade Organization had ruled amounted to an illegal export subsidy. The Act goes well beyond addressing the illegal subsidy and creates billions of dollars of new tax breaks for a broad spectrum of taxpayers. However, it is fully offset by a number of revenue provisions. Although many of the provisions are discussed later in this Hot Topic, below is a brief outline of key provisions of the Act, which is over 600 pages long.

- **Repeal of Exclusion for Extraterritorial Income (ETI)**

  - For transactions after 2004, the Act repeals the ETI system of tax benefits subject to transition relief for 2005 and 2006 and grandfather rules for contracts entered into before September 18, 2003.

  - For tax years beginning after 2004, the Act provides a 9% deduction (equal to a 3% rate cut) on all manufacturing (and certain other domestic production) activity undertaken in the U.S., whether it is exported or not. The deduction is available to C corporations, S corporations, partnerships, sole proprietorships, cooperatives and estates and trusts, and is allowed for AMT purposes. The deduction is phased in over five years: 3% in 2005-2006, 6% for 2007-2009, 9% after 2009.

- **Business Tax Incentives**

  - The Act extends for an additional two years the increased amounts which a taxpayer may expense under Code Sec. 179 so it continues through 2007 tax years.

  - The Act directs IRS to issue new regulations for the designation of targeted areas for the new markets tax credit.

  - For tax years beginning after 2004, the Act allows family members to elect to be treated as one shareholder for purposes of determining the number of S shareholders of an S corporation and increases the maximum number of shareholders from 75 to 100.

  - The Act allows an IRA to hold S corporation bank stock which the IRA held on the enactment date with the IRA owner treated as the shareholder and allows the stock to be sold to the beneficiary for fair market value upon the corporation making an S election.

  - For tax years beginning after 2004, the Act disregards unexercised powers of appointment in determining the potential current beneficiaries of an electing small business trust (ESBT), and increases the period during which a trust can dispose of stock after an ineligible shareholder becomes a potential current beneficiary from 60 days to one year.

- For tax years beginning after 2004, the Act allows suspended losses to be transferred with transfers of S stock to a spouse or former spouse incident to divorce.

- For tax years beginning after 2004, the Act permits a beneficiary of a qualified Subchapter S trust (QSST) to deduct suspended losses under the at-risk and passive loss rules when the trust disposes of S stock.

- For tax years beginning after 2004, the Act provides relief from inadvertently invalid QSub elections and terminations and allows QSubs to file information returns.

- For distributions after 1997, the Act permits an S corporation to use distributions on stock held by its ESOP to repay loans, provided stock of at least equal value is allocated to participant accounts.

- For SBICs formed after the enactment date, the Act excludes from the debt-financed property rules debt incurred by an SBIC which is evidenced by a debenture issued by it under section 303(a) of the Small Business Investment Act of 1958 and which is held or guaranteed by the Small Business Administration.

- For tax years beginning after the enactment date, the Act generally allows corporations to elect a "tonnage tax" on their taxable income from certain shipping activities in lieu of the U.S. corporate income tax.

- For options exercised after the enactment date, the Act excludes certain stock options and stock purchase plans from employee wages for payroll tax and income tax withholding purposes.

- The Act extends the 50% bonus depreciation for small aircraft by one year so it applies through 2005.

■ **Agricultural Tax Relief and Incentives**

- The Act repeals the reduced rates of excise tax for most alcohol-blended fuels and instead creates two new excise tax credits: the alcohol fuel mixture credit and the biodiesel mixture credit.

- For any tax year for which the due date (without regard for extensions) for the return is after 2002, if a rancher is forced to sell livestock as a result of drought he must pay tax on any gain unless he reinvests in livestock or, as added by the Act, in other ranch equipment or property, within 4 years (increased from 2-years under pre-Act law).

- Effective after the enactment date, the Act provides, to the extent provided in organizational documents of the cooperative, dividends on capital stock won't reduce patronage income or prevent the cooperative from being treated as operating on a cooperative basis.

- For tax years after the enactment date, the Act provides the small producers tax credit flows through to cooperative members.

- For tax years beginning after 2003, the Act extends the option of income averaging, which under pre-Act law is available to farmers, to individuals engaged in the trade or business of fishing and it coordinates income averaging with the AMT so use of averaging won't increase AMT.

- The Act provides capital gains treatment on the outright sale of timber by a landowner after 2004.

Tax Reform and Simplification for U.S. Businesses

- The Act includes several provisions to reduce double taxation of U.S.-based companies, such as reducing the foreign tax credit (FTC) baskets from nine to two for tax years beginning after 2004 and allowing FTCs to be carried forward for 10 years instead of five for excess foreign tax credits which may be carried to any tax years ending after the enactment date.

- For tax years beginning after 2004, the Act repeals the 90-percent limitation on the use of FTCs against AMT.

- The Act encourages companies to reinvest foreign earnings in the U.S. by temporarily taxing repatriated income at 5.25% for tax years ending on or after the enactment date.

Deduction of State and Local General Sales Taxes

- The Act allows taxpayers to deduct state and local sales taxes instead of state income taxes for 2004 and 2005. Taxpayers may deduct their actual sales taxes or use IRS-published tables.

Miscellaneous Provisions

- For property acquired after 2004 and before 2010, the Act excludes from unrelated taxable income of tax-exempt investors gain or loss from the sale or exchange of a qualifying brownfield property and excepts such property from the debt-financed property rules.

- For a judgment or settlement occurring after the enactment date, the Act allows an above-the-line deduction for attorney's fees and court costs incurred in connection with an unlawful discrimination claim.

- Generally for electricity sold and produced after the enactment date, the Act expands the credit for electricity produced from renewable resources to include open-loop biomass, geothermal and solar energy, small irrigation power, landfill gas, trash combustion and refined coal production facilities.

- For tax years ending after the enactment date, the Act allows the tax credits for alcohol fuels and for the production of electricity to be applied against AMT.

- **Revenue Provisions**

  The Act offsets costs by, among other items:

  - Reducing tax avoidance through corporate inversions and individual expatriation.
  - Shutting down abusive tax shelters.
  - Closing various loopholes.
  - Combating fuel tax evasion.
  - Tightening the rules for charitable contributions of (i) patents and similar property made after June 3, 2004, and (ii) motor vehicles, boats and airplanes made after 2004.
  - Making it more difficult to defer tax on nonqualified deferred compensation for amounts deferred in tax years beginning after 2004.
  - Extending IRS user fees.
  - Limiting the amount of the cost of an SUV which may be expensed in a single year to $25,000 for property placed in service after the enactment date.

ETI REPEAL AND THE U.S. PRODUCTION ACTIVITIES DEDUCTION UNDER THE ACT

The driving force behind the recently enacted Act was the need to repeal the export subsidies which had been found to be in violation of World Trade Organization (WTO) agreements. The violations had provoked the European Union (EU) to impose tariffs on U.S. companies. However, the Act goes far beyond simply repealing the export subsidies, and instead ushers in a breathtakingly large variety of tax incentives and revenue offsets which apply both widely and to specialized industries and taxpayers. The centerpiece of the legislation is a new deduction for production activities conducted in the U.S. Here are more details regarding these important provisions.

- **ETI repeal**

  The Act repeals the ETI exclusion. The repeal is effective for transactions occurring after December 31, 2004, except for transition relief. Under the transition rules: (1) the ETI exclusion continues to apply to transactions in the ordinary course of business which are pursuant to a binding contract in effect on September 17, 2003, and at all times thereafter; and (2) taxpayers are provided with 80% of their otherwise-applicable ETI benefits during 2005 and 60% of their otherwise-applicable ETI benefits during 2006.

- **New deduction for U.S. production activities**

  The Act replaces ETI with a new tax deduction for domestic production activities. The deduction is a percentage of the net income from those activities - 3% in 2005-2006, 6% for 2007-2009, 9% after 2009. When fully phased in, the deduction is designed to be economically equivalent to a 3% reduction in the tax rate on U.S.-based production activities. The amount of the deduction for any tax year may not exceed

50% of the employer's W-2 wages for that tax year. The deduction is available to all taxpayers with qualified production activities income and it is allowable in computing AMT income.

The U.S. production activities deduction is allowed with respect to a taxpayer's qualified production activities income, which is the taxpayer's domestic production gross receipts net of expenses. "Domestic production gross receipts" are receipts derived from any of the following:

- Any lease, rental, license, sale, exchange or other disposition of -
  - qualifying production property (i.e., tangible personal property, any computer software and certain sound recordings) which was manufactured, produced, grown, or extracted in whole or in significant part by the taxpayer within the U.S.;
  - any qualified film produced by the taxpayer; or
  - electricity, natural gas and potable water produced by the taxpayer in the U.S.
- Construction performed in the U.S.
- Engineering and architectural services performed in the U.S. for construction projects in the U.S.

For pass-thru entities (such as S corporations, partnerships, estates and trusts), the deduction generally is determined at the shareholder, partner or similar level by taking into account at that level the proportional share of the qualified production activities income of the entity. Patrons of agricultural cooperatives may also qualify for the deduction, under slightly different rules.

BUSINESS TAX INCENTIVES

In addition to the new deduction for U.S. production activities, the Act spreads billions of dollars of tax breaks throughout the business world. These include:

- An important provision for small businesses and self-employed individuals in the recently passed American Jobs Creation Act of 2004 is the extension through 2007 of the small business expensing provision which allows businesses to expense up to $100,000 of assets instead of depreciating them over several years.
  Federal tax law provides, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. For tax years beginning in 2003, tax legislation in 2003 increased the amount a taxpayer may deduct to $100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property is defined as depreciable tangible personal property (and certain computer software) purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation ($102,000 and $410,000 for 2004).

  For 2006 and later years, however, the $100,000 limit was scheduled to drop to

$25,000.

The new law extends the $100,000 expensing limit for two more years, through 2007. It also extends for two years (1) the $400,000 amount, (2) the provision which includes certain computer software as qualifying property, and (3) a provision permitting taxpayers to revoke an expensing election on an amended return without the consent of the IRS.

- 15-year writeoff for qualifying leasehold improvements and restaurant property.

- a direction to IRS to issue new regulations for the designation of targeted areas for the new markets tax credit.

- an elective tonnage tax system for international shipping income.

S CORPORATION PROVISIONS

The significant changes relating to S corporations are summarized as follows:

- **Members of family treated as one shareholder**

  S corporations are limited as to the number of shareholders they may have. For purposes of determining the number of shareholders, the new law permits corporations to elect to treat all members of a family (up to six generations) as one shareholder.

- **Increase in maximum number of shareholders**

  The Act increases the maximum number of eligible shareholders in an S corporation from 75 to 100.

- **Unexercised powers of appointment disregarded in determining potential current beneficiaries of electing small business trusts (ESBTs)**

  For purposes of whether a corporation satisfies the S corporation requirements, each person entitled to receive a distribution (or who may receive a discretionary distribution) from an ESBT ("potential current beneficiary") is treated as a shareholder. This prevented ESBTs from holding shares subject to a power of appointment unless all potential appointees are eligible to be S corporation shareholders and do not exceed the limit on the number of shareholders. Under the new law, powers of appointment are disregarded in determining the potential current beneficiaries of an ESBT to the extent they are not exercised.

- **Transfers of suspended losses incident to divorce**

  Under pre-Act law, any loss or deduction which is not allowed to a shareholder of an S corporation because the loss exceeds the shareholder's basis in stock and debt of the corporation is carried forward, but cannot be transferred. The new law modifies that rule by providing if a shareholder's stock in an S corporation is transferred to a spouse (or to a former spouse) incident to a divorce, any suspended loss or deduction relating to such stock is transferred to and may be carried over by the transferee spouse. In effect, the spouse or former spouse steps into the shoes of the transferor and can claim suspended losses in subsequent tax years if the S corporation has taxable income or the transferee acquires basis in the stock or debt by making capital contributions or making additional loans.

- **Use of passive activity loss and at-risk amounts by Qualified Subchapter S Trust (QSST) income beneficiaries**

  Under the passive activity and at-risk rules, suspended losses can be taken when the taxpayer disposes of its entire property interest. However, for purposes of the passive activity and at risk rules, the trust (not the beneficiary) was treated as the owner of the S corporation stock. The new law provides the beneficiary of a QSST may deduct suspended losses under the at-risk rules and the passive loss rules when the trust disposes of the S stock.

- **Exclusion of investment securities income from passive investment income test for bank S corporations**

  An S corporation (with earnings and profits from C corporation years) is subject to corporate-level tax, and may even be subject to termination, if its passive investment income reaches too high a level. Passive investment income generally means gross receipts from royalties, rents, dividends, interest, annuities and sale or exchanges of stock or securities (to the extent of gains). The new law provides interest income and dividends on assets required to be held by a bank (or a bank holding company) are not treated as passive income for purposes of the S corporation passive investment income rules.

- **Relief from inadvertently invalid qualified Subchapter S subsidiary elections and terminations**

  The new law allows inadvertent invalid qualified Subchapter S subsidiary elections and terminations to be waived by the IRS.

- **ESOPs and S corporations**

  The new law allows ESOPs which borrow money to buy S corporation employer stock to use distributions on the stock to repay the loans. However, where the stock is allocated to a participant, this is allowed only to the extent stock of at least equal value is allocated to the participant's account. This relief is effective for distributions after 1997.

STOCK OPTIONS AND PAYROLL TAXES

The Act made several major changes to compensation and benefit provisions of the tax law. Specifically, the new law excludes incentive stock options and employee stock purchase plan stock options from FICA/FUTA wages.

- **Exclusion of incentive stock options and employee stock purchase plan stock options from wages**

  Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. In the case of an incentive stock option (ISO) or an option to purchase stock under an employee stock purchase plan (ESPP) (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise. If the statutory holding period requirements are satisfied with respect to stock acquired through the exercise of a statutory stock option, the spread, and any additional appreciation, will be taxed as a capital gain upon disposition of such stock. Compensation income is recognized, however, if there is a disqualifying disposition (i.e., if the statutory holding period is not satisfied) of stock acquired pursuant to the exercise of a statutory stock option.

In the past, there has been uncertainty as to employer withholding obligations upon the exercise of statutory stock options. On June 25, 2002, the IRS announced, until further notice, it would not assess FICA or FUTA upon the exercise by an employee of an incentive stock option or impose Federal income tax withholding obligations, upon either the exercise of a stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.

- **New law excludes ISOs and ESPP stock options from wages**

The Act provides a specific exclusion from FICA/FUTA payroll tax withholding obligations for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock.

The new law also provides Federal income tax withholding is not required on a disqualifying disposition of stock acquired from ISOs and ESPPs, nor when compensation is recognized in connection with an ESPP discount.

AGRICULTURAL TAX RELIEF AND INCENTIVES

The recently passed Act provide targeted relief to farmers, ranchers, woodlot owners and agricultural cooperatives.

- **Livestock sold on account of weather-related conditions**

Under pre-Act law gain from the sale of livestock due to drought, flood or other weather-related conditions could be deferred by reinvesting in livestock within two years. Under the Act, the two-year period is extended to four years and the rancher is permitted to reinvest in other ranch equipment or property, as well as livestock. The extended period also applies for purposes of the election to defer gain from forced sales of livestock due to weather-related conditions by cash basis farmers. These changes are effective for any tax year for which the due date of the return is after 2002.

- **Coordination of farmer and fisherman income averaging with the AMT**

A noncorporate taxpayer engaged in a farming business may elect to compute his current year tax liability by averaging, over the prior three-year period, all or a portion of their taxable income from the trade or business of farming. Under pre-Act law, because income averaging reduced the regular tax liability, the alternative minimum tax (AMT) could have been increased and the benefits of farmer income averaging could have been reduced or eliminated for those subject to AMT. The Act, however, extends the option of income averaging to individuals engaged in the trade or business of fishing and coordinates income averaging with the AMT so use of averaging won't increase AMT for both farmers and fishermen. These provisions are effective for tax years beginning after 2003.

- **Timber relief provisions**

The Act provides several tax relief provisions for timber. These include providing capital gains treatment for outright sales of timber. Under pre-Act law, landowners had to meet the requirement that they retain an economic interest in the timber they disposed of in order to receive capital gains treatment. Under the Act, for a post-2004 sale of timber by the owner of the land from which the timber is cut, the requirement that a taxpayer retain an economic interest in the timber in order to treat gains as capital gain does not apply.

Another timber provision concerns the expensing of reforestation costs. Under pre-Act law, a taxpayer generally could amortize over a seven-year period up to $10,000 of reforestation expenditures incurred each year with respect to qualified timber property. In addition, a 10% general business credit was allowed for these amortizable reforestation expenditures. The Act permits a taxpayer to elect to expense up to $10,000 of reforestation expenditures with respect to each qualified timber property each year. Expenditures above $10,000 can be amortized over 84 months. The reforestation tax credit is repealed. These provisions are effective for expenditures paid or incurred after the date of enactment of the Act.

Another provision affects the election to treat the cutting of timber as a sale or exchange. Under pre-Act law, a taxpayer could elect to treat the cutting of timber as a sale or exchange of the timber. If the election was made, gain or loss was recognized in an amount equal to the difference between the fair market value of the timber and the basis of the timber. An election, once made, was effective for the taxable year and all subsequent taxable years, unless the IRS, upon a showing of undue hardship by the taxpayer, permitted the revocation of the election. If an election was revoked, a new election could be made only with the consent of the IRS. Under the Act, an election by a taxpayer for a taxable year ending on or before the date of enactment to treat the cutting of timber as a sale or exchange may be revoked by the taxpayer without the consent of the IRS for any taxable year ending after that date. The prior election (and revocation) is disregarded for purposes of making a subsequent election.

- **Patronage income for co-op dividends**

Both "exempt" farmers' co-ops and nonexempt co-ops generally are entitled to deduct or exclude amounts distributed as patronage dividends. A patronage dividend represents distributions of net earning among the cooperators and other patrons on the basis of each person's patronage. Net earnings are reduced by dividends paid on capital stock under the dividend allocation rule.

Under pre-Act law, the dividend allocation rule required dividends on capital stock be allocated between a cooperative's patronage and nonpatronage operations, with the amounts allocated to patronage operations reducing the net earnings available for the payment of patronage dividends.

The Act provides, to the extent provided in organizational documents of the cooperative, dividends on capital stock won't reduce patronage income or prevent the cooperative from being treated as operating on a cooperative basis.

- **Election to pass through small ethanol producer credit to co-op members**

  Under pre-Act law, the only excess credits which a cooperative could pass through to its patrons were the rehabilitation credit, the energy property credit and the reforestation credit. For tax years after the enactment date, the Act provides that the small producers tax credit can flow through to cooperative members (patrons). If the election is made to do so, the credit must be apportioned to members eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such members for the tax year. The election must be made on a timely filed return for the tax year and once made, is irrevocable for that year.

  Also, you may be interested to know Congress also extended ethanol subsidies and created a new biodiesel fuel income tax credit for fuel sold or produced after 2004. The Act also extends the alcohol fuel income tax credit through December 31, 2010.

  In addition, for fuel sold or used after 2004, the Act (1) repeals the reduced rates of excise tax for most alcohol-blended fuels and imposes the full rate of excise tax on most alcohol-blended fuels; and (2) creates two new refundable excise tax credits, namely, the alcohol fuel mixture credit through December 31, 2010, and the biodiesel mixture credit through December 31, 2006. Finally, the Act provides certain safe harbor rules for timber REITs.

STATE AND LOCAL SALES TAX DEDUCTIBILITY IN THE ACT

Many residents of states with a sales tax but no or a limited individual income tax just received a tax cut as a result of the recently passed Act. That's because, under the new law, taxpayers may choose between taking state sales taxes and state income taxes as an itemized deduction on their Federal tax return for 2004 and 2005. Although the law applies nationwide, its primary beneficiaries will be citizens in the states which have sales tax but no or a limited individual income tax.

- **Sales tax not deductible under prior law**

  Under prior law, Federal income tax filers who itemized could deduct state and local income and property taxes when computing Federal taxable income, but could not deduct state and local sales taxes. Taxpayers in non-income tax states argued this differing tax treatment was unfair.

- **Deductibility of sales tax under the new law**

  The new law addresses this inequity by allowing taxpayers to choose an itemized deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes. Although the measure allows taxpayers in all states to choose between deducting state and local sales taxes or state and local income taxes on their Federal tax returns, a person typically pays more in income taxes than in sales taxes. Therefore, taxpayers in states without individual income taxes are primarily the ones who will benefit under the provision. These states are Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Taxpayers in states with a limited individual income tax may also benefit. (New Hampshire imposes an income tax only on interest and dividends; Tennessee on income from stocks and bonds.)

As noted above, the tax break can be used only by those who itemize their tax deductions. Taxpayers who take the standard deduction instead of itemizing receive no benefit from this provision. The deduction is in effect for 2004 and 2005, but extension to future years is possible.

So that families won't need to keep a shoe box of sales receipts, the new law gives taxpayers the option of using IRS sales tax tables and adding actual sales taxes paid for cars, boats and such other major items as the IRS may decide.

THE ACT PROVIDES UP TO $5,000 FIRST YEAR EXPENSING OF BUSINESS START-UP EXPENDITURES

Under pre-2004 law, no current deduction was allowed for start-up expenditures. However, a taxpayer could have elected to treat start-up expenditures as deferred expenses and deducted the expenditures equally over a period of not less than 60 months beginning with the month in the active trade or business began.

Start-up expenses are amounts paid or incurred for:

1. investigating the creation or acquisition of an active trade or business,

2. creating an active trade or business, or

3. activities engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of the activities becoming an active trade or business.

The expenditure must be one which would have been allowable as a deduction in the tax year paid or incurred if it were paid or incurred in connection with the operation of an existing active trade or business in the same field.

Common types of start-up expenses include:

- advertising costs;

- salaries and wages paid to employees and their instructors for training;

- travel and related expenses incurred in the course of finding potential distributors, suppliers and customers;

- salaries and fees paid to executives and consultants, as well as for professional services.

  - **New Law**

A taxpayer can elect a current deduction for a limited amount (up to $5,000) of start-up expenditures in the tax year in which the trade or business begins. However, this $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeds $50,000. The remainder of the start-up expenditures can be claimed as a deduction ratably over a 15-year period.

Specifically, an electing taxpayer is allowed a deduction for the tax year in which the active trade or business begins in an amount equal to the *lesser* of:

- the amount of start-up expenditures with respect to the active trade or business; or

- $5,000, reduced (but not below zero) by the amount by which the start-up expenditures exceed $50,000.

  Observation: Thus, if an individual's start-up expenses are $5,000 or less, he can deduct those expenses in full in the year he begins the active trade or business.

  Illustration 1: A, a calendar year individual taxpayer, incurs $4,000 of start-up expenses for an air conditioning repair business he began in November of Year 1. A can deduct the entire $4,000 on his Year 1 tax return.

The remainder of the start-up expenditures are deductible ratably over a 180-month period beginning with the month in which the active trade or business begins. This is consistent with the amortization period for other intangibles.

Illustration 2: Same facts as illustration (1) except A's start-up expenses are $14,000. In Year 1, A can deduct $5,100 ($5,000 + $100 [$9,000 ÷ 180 × 2 months]) of his start-up expenditures. The remaining $8,900 is deductible ratably, i.e., at $50 per month over the next 178 months, i.e., in Years 2 through 16.

Illustration 3: B, a calendar year individual taxpayer, incurs $53,000 of start-up expenses for an auto dealership which began business in July of Year 1. B's Year 1 deduction is $3,700 ($5,000 - $3,000 [start-up costs over $50,000] + $1,700 [$51,000 ÷ 180 × 6 months]). The remaining $49,300 is deductible ratably i.e., at $283.33 per month, over the next 174 months.
Illustration 4: Same facts as illustration (3) except B's start-up expenses are $180,000. B deducts the entire $180,000 ratably over 180 months, i.e., $1,000 per month, beginning July of Year 1. B's Year 1 deduction is $6,000 ($1,000 ×× 6 months).

Note: The deduction and amortization election does not apply to start-up costs related to a trade or business which never becomes an active trade or business, e.g., one which fails in the planning, search or pre-opening phase. But these expenses may be deductible under the Code Sec. 165 loss rules.

- **Effective**

Amounts paid or incurred after date of enactment, October 22, 2004. Start-up expenditures incurred on or before date of enactment continue to be eligible for 60 month amortization. However, all start-up expenditures related to a particular trade or business, whether incurred before or after date of enactment, are considered in determining whether the cumulative cost of start-up expenditures exceeds $50,000.

MANY WILL SAVE MORE TAX BY DONATING AUTOS TO CHARITY THIS YEAR RATHER THAN NEXT

A taxpayer thinking of donating a used auto to charity should consider doing so before 2005 in order to maximize his deduction. That's because the Act toughens the rules for charitable donations of autos made after 2004.

- **Pre-2005 rules**

  Under pre-Act law, if the total charitable deduction claimed by an individual for noncash property exceeds $500, the individual must file IRS Form 8283, Noncash Charitable Contributions, with the IRS. If the gift is more than $5,000, the taxpayer is required to obtain a qualified appraisal. The appraisal needn't be attached to the return except in the case of gifts of art valued at more than $20,000. C corporations (other than a closely-held corporation, a personal service corporation or an S corporation) were not required to obtain a qualified appraisal.

- **Post-2004 rules**

  The Act generally limits the deduction for motor vehicles (as well as for boats and airplanes) contributed to charity after 2004 for which the claimed value exceeds $500 by making it dependent upon the charity's use of the vehicle and imposing higher substantiation requirements. If the charity sells the vehicle without any "significant intervening use" (actual, significant use of the vehicle to substantially further the organization's regularly conducted activities) or "material improvement" (e.g., major repairs), the donor's charitable deduction can't exceed the gross proceeds from the charity's sale.) Additionally a deduction for donated vehicles whose claimed value exceeds $500 is not allowed unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment from the donee. The acknowledgment must contain the name and taxpayer identification number of the donor and the vehicle identification number (or similar number) of the vehicle. In addition, if the charity (donee) sells the vehicle without performing a significant intervening use or material improvement of it, the acknowledgment must say it was sold in an arm's length transaction between unrelated parties and state the gross proceeds from the sale and the deductible amount may not exceed the gross proceeds.

  > **Observation:** Under the pre-2005 rules, ultimately, it's left to the donor to determine what an under-$5,000 vehicle is worth. A detailed receipt from the charity (e.g., showing the donee's name, date and location of the contribution and a description of property in detail reasonably sufficient under the circumstances), plus a "blue book" printout and the donor's knowledge of the car's condition and mileage (plus, preferably a contemporaneous photo) should give the donor enough information to arrive at a fair value which can withstand scrutiny in the event of an audit.

  > **Recommendation:** Individuals who donate used cars to charities in 2004 should document their condition and not be overly aggressive in valuing the cars.

NEW RULES IN THE ACT AFFECTING OTHER CHARITABLE CONTRIBUTIONS

The new provisions in the Act include requirements for increased charitable reporting for noncash gifts and a crackdown on gifts of patents.

- **Increased reporting for noncash charitable contributions**

  The new law brings two major changes to this area. First, it makes the qualified appraisal rule for noncash gifts over $5,000 applicable to corporations. Second, if the amount of the contribution of property other than cash, inventory or publicly traded securities exceeds $500,000, the donor (whether an individual, partnership or corporation) must attach the qualified appraisal to the donor's tax return. The new rules take effect for contributions made after June 3, 2004.

- **New restrictions on the deductibility of patents and other intellectual property**

  Under pre-Act law, charitable contributions of patents and other intellectual property were deductible at fair market value. This rule was subject to abuse, as patents and other intellectual property were often donated using excessive valuations, resulting in inflated tax deductions for donors.

  The new law puts an end to this practice by providing the donor's initial charitable deduction is limited to the lesser of the donor's basis or the fair market value of the property. Since creators usually have a low basis in their patents, the deduction in most cases will be relatively small. However, if the charity actually goes on to receive income from the patent or other intellectual property (referred to as "qualified donee income," or QDI), the donor may then take additional charitable deductions for QDI generated in the ten-year period starting on the date of the gift. The deduction begins at 100% of the QDI received in the year of the contribution and declines to 10% of the QDI by the end of the period. The charity is required to report the amount of QDI attributable to the patent or other intellectual property to the donor and the IRS. These rules also take effect for contributions made after June 3, 2004.

EQUITY AND DEFERRED COMPENSATION CHANGES IN THE ACT

Prompted by corporate scandals at Enron and other companies, the Act imposes certain restrictions and limitations on the design of nonqualified deferred compensation plans. While these new rules may limit, somewhat, the flexibility which makes these plans popular with both employers and employees, the new rules do have the advantage of offering clear guidelines for employers and their advisors to follow when designing and administering plans. Until now, the only guidelines have been the expert interpretation of case law and from the IRS. The new rules add certainty to the nonqualified deferred compensation area.

- **What is a nonqualified deferred compensation plan?**

  For these purposes a "nonqualified deferred compensation plan" is any "plan" which provides for the deferral of compensation, other than:

  - a "qualified employer plan" (a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE plan, qualified governmental excess benefit arrangement under Code Sec. 415(m) , or eligible deferred compensation plan under Code Sec. 457(b)), and

- any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

- **Taxation**

  Under the new law, for deferred compensation to be excluded from gross income, the deferred compensation plan must meet distribution, acceleration of benefits and election requirements. If a plan fails to meet the requirements, all compensation earned and deferred must be included in income for the first tax year the nonqualified deferred compensation plan fails to meet the requirements, to the extent not subject to a "substantial risk of forfeiture" and not previously included in gross income. A 20% penalty will also be imposed on the amount required to be included in income. Interest will also be assessed on the underpayment, at the underpayment rate plus one percentage point.

- **Restrictions on distributions**

  Under the new law, a nonqualified deferred compensation plan may not permit distributions from the plan earlier than separation from service, death, disability, a specified time (or pursuant to a fixed schedule), a change in control of a corporation (to the extent allowed by the IRS) or an occurrence of unforeseeable emergency. Additionally, key employees at public corporations generally may not receive their distributions earlier than six months after separation. Calling down benefits with a "haircut" (i.e., forfeiture of a portion of the account balance in exchange for access to the plan account) is not a distribution option.

- **Acceleration of benefits**

  The Act does not permit a plan to allow for the acceleration of benefits.

- **Requirements relating to the timing of deferral elections**

  Under the new law, deferral elections generally must be made in the tax year preceding the year in which the services are performed, or within 30 days of becoming eligible for plan participation. If the award is performance-based (i.e., an incentive bonus), the election must be made not later than six months before the end of the performance period.

- **Delay of distributions or changes to form of distribution**

  Under the new rules, any subsequent election for an award generally must be made at least 12 months after the election and must defer receipt for at least five years in the future.

- **Prohibition on offshore funding**

  Although the use of rabbi trusts (trusts which are subject to the claims of general creditors) will still be available to employers in connection with nonqualified deferred compensation, the new rules generally prohibit the use of offshore rabbi trusts. Also, rabbi trusts which are convertible into secular trusts (protecting the assets from general creditors) are prohibited.

- **Trigger upon financial health**

A deferred compensation plan may not provide that a deterioration in the financial status of the employer will trigger payment of the deferred compensation.

- **Exception**

The committee report clarifies Code Sec. 409A will *not* apply to annual bonuses, or other annual compensation amounts, paid within two and one-half months after the close of the tax year in which the services were performed.

> **Observation:** A severance plan technically will be subject to Code Sec. 409A. Typical severance which is payable at termination of employment will be includible in a terminated employee's gross income in the tax year in which the severance pay is not subject to a substantial risk of forfeiture, i.e., in the tax year in which the individual is terminated-whether or not the plan meets the Code Sec. 409A requirements. But if a plan calls for the payment of severance to be delayed for a period of time after the individual's right to it is vested, then presumably the severance plan will have to meet the new requirements in order to avoid immediate taxation of the delayed severance.
>
> According to the Conference Report, Code Sec. 409A is *not* intended to change the tax treatment of statutory stock options-i.e., incentive stock options (ISOs) and employee stock purchase plan (ESPP) options. It also says Code Sec. 409A will not affect an arrangement taxable under Code Sec. 83 providing for the grant of an option on employer stock with an exercise price not less than the fair market value of the underlying stock on the date of grant, *if* the arrangement does not include a deferral feature other than the option holder's right to exercise the option in the future.
>
> **Observation:** Thus, Code Sec. 409A will not apply to nonqualified stock option plans in which the strike price is at least equal on option grant to the option stock's fair market value provided the plan has no deferral feature other than the option holder's future right to exercise the option.

The term "plan" includes any agreement or arrangement, including an agreement or arrangement which includes one person. The Committee Report says Code Sec. 409A 's application is *not* limited to arrangements between an employer and employee.

> **Observation:** Thus, a deferred compensation arrangement with a single corporate director or other independent contractor may be subject to Code Sec. 409A.

- **Effective date of new rules**

The new rules, which contain transitional and anti-abuse rules, generally apply to amounts deferred after December 31, 2004.

REVENUE PROVISIONS

To pay for the benefits, the Act imposes scores of new costs on taxpayers. Among other items, it includes:

NEW LIMITS ON EXPENSING OF SPORT UTILITY VEHICLES (SUVs)

For tax years beginning in 2004, taxpayers (other than trusts, estates and certain non-corporate lessors) may elect to expense under Code Sec. 179 up to $102,000 of the cost of eligible personal property used in the active conduct of a trade or business. The maximum expensing amount generally is phased out dollar-for-dollar by the amount of qualified expensing-eligible property placed in service during the tax year in excess of $410,000 (for 2004). Additionally, the maximum expensing amount is limited to the amount of taxable income from any of the taxpayer's trades or businesses. The expensing election may be claimed for "listed property" (e.g., car, SUV) only if it is used more than 50% in a qualified business use and only to the extent of the property's business use. Qualified business use does not include, among other items, the use of listed property as compensation for services by a 5% owner or a related person.

Depreciation dollar caps apply under Code Sec. 280F to the combined allowable deduction under Code Sec. 179 and MACRS depreciation for "passenger autos." For example, the maximum first-year combined expensing and depreciation deduction for vehicles bought and placed in service in 2004 is:

- $2,960 for an auto (not a light truck or van) which is bought and placed in service in 2004 and does not qualify for bonus first-year depreciation (e.g., because it was previously owned) and $10,610 if it does qualify for bonus depreciation.

- $3,260 for a light truck or van (passenger auto built on a truck chassis, including minivans and sport-utility vehicles (SUVs) built on a truck chassis) which does not qualify for bonus first-year depreciation and $10,910 if it does qualify for bonus depreciation.

A vehicle is a "passenger auto" subject to the above limitations if it is: (1) a car (not a truck or van) which is rated at 6,000 pounds unloaded gross vehicle weight or less; or (2) a light truck or van (passenger autos built on a truck chassis, including minivans and sport-utility vehicles (SUVs) built on a truck chassis) which is rated at 6,000 pounds gross (loaded) vehicle weight or less. Certain non-personal-use vehicles (e.g., ambulance or hearse) are exempt from the luxury auto limits regardless of weight.

Heavy SUVs - those with a gross (loaded) vehicle weight rating (GVWR) of more than 6,000 pounds-are exempt from the luxury-auto dollar caps because they fall outside of the definition of a passenger auto. There are some 40-plus models which qualify as heavy SUVs (the GVWR is stamped on a label on the inside of the driver's door). Because they fall outside of this definition, the cost of most heavy SUVs used 100% for business may be expensed under Code Sec. 179 . Thus, for example, the entire cost of a $40,000 SUV bought new in March, 2004, and used 100% for business may be expensed under pre-Act law.

- **New law**

  For property placed in service after the enactment date, the Act limits the ability of taxpayers to claim deductions under Code Sec. 179 for certain vehicles not subject to

Code Sec. 280F to $25,000. The change applies to sport utility vehicles rated at 14,000 pounds gross vehicle weight or less (in place of the pre-Act law 6,000 pound rating). For this purpose, a sport utility vehicle is defined to exclude any vehicle which: (1) is designed for more than nine individuals in seating rearward of the driver's seat; (2) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or (3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the drivers seat and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Illustration: During 2005, a calendar year taxpayer acquires and places in service a sport utility vehicle subject to the new rule which costs $70,000. The vehicle otherwise qualifies for the expensing election. Under the new law, the taxpayer is first allowed a $25,000 deduction under Code Sec. 179 . The taxpayer is also allowed an additional first-year depreciation deduction of $22,500 based on $45,000 ($70,000 original cost less the expensing deduction of $25,000) of adjusted basis. Finally, the remaining adjusted basis of $22,500 ($45,000 adjusted basis less $22,500 additional first-year depreciation) is eligible for an additional depreciation deduction of $4,500 under the general depreciation rules (automobiles are five-year recovery property). The remaining $18,000 of cost ($70,000 original cost less $52,000 deductible currently) would be recovered in 2006 and subsequent years under the general depreciation rules.