RECAP OF BUSINESS TAX LAW CHANGES GOING INTO EFFECT IN 2005

Many important tax changes became effective January 1, 2005. apart from the numerous indexing changes. These changes primarily result from the Working Families Tax Relief Act of 2004 (WFTRA) and the American Jobs Creation Act of 2004 (Jobs Act). However, some also derive from earlier legislation with phased-in changes, such as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and IRS guidance.

This Hot Topic covers business non-indexing changes that first go into effect in 2005.

■ ETI Repeal

- **Exclusion for extraterritorial income (ETI) repeal.**

  For transactions after 2004, the Jobs 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.

- **New tax deduction for domestic production activities.**

  For tax years beginning after 2004, under the Jobs Act, subject to the 50% - of - W-2 wages limitation, taxpayers are allowed a deduction-the U.S. production activities deduction - equal to a specified percentage (see below) of the lesser of:

  < taxpayer's "qualified production activities income" for the tax year (i.e., net income from U.S. manufacturing, production (including electricity, natural gas and potable water production), growth (including food production, food storage, and food processing), or extraction activities, U.S. film production, U.S. construction activities and U.S. engineering and architectural services), or

  < the taxpayer's taxable income, or, in the case of an individual, adjusted gross income (with modifications), for the tax year.

The percentage is 3% in 2005 - 2006, 6% for 2007 - 2009, 9% after 2009.

- **AMT treatment of deduction for production activities.**

  The U.S. production activities deduction is allowed for purposes of computing alternative minimum taxable income. However, in computing alternative minimum taxable income, the deduction is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to the U.S. production activities deduction.

The new deduction also is allowed in computing a corporation's adjusted current earnings (ACE) adjustment.

- **S Corporation Reforms**

  - **Maximum number of eligible S shareholders increased**

    For tax years beginning after 2004, the maximum number of shareholders is 100 (increased from 75).

  - **Election to treat family members as one S shareholder**

    For tax years beginning after 2004, family members may elect to be treated as one shareholder for purposes of determining the number of shareholders of an S corporation. A family is defined as the common ancestor and all lineal descendants of the common ancestor, as well as the spouses, or former spouses, of these individuals. An individual is not considered a common ancestor if, as of the later of the time of the election or the effective date of this change, the individual is more than six generations removed from the youngest generation of shareholders who would (but for this rule) be members of the family. For purposes of this rule, a spouse or former spouse is treated as in the same generation as the person to whom the individual is (or was) married. Except as provided by regulations, the election for a family may be made by any family member and remains in effect until terminated.

  - **Potential current beneficiaries of ESBT**

    For tax years beginning after 2004, unexercised powers of appointment are disregarded in determining the potential current beneficiaries of an electing small business trust (ESBT), and the period during which a trust can dispose of stock after an ineligible shareholder becomes a potential current beneficiary is increased to one year.

  - **Transfers of suspended S losses to spouse or former spouse**

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

  - **QSST income beneficiaries**

    For transfers made after 2004, a beneficiary of a qualified subchapter S trust (QSST), may deduct suspended losses under the at-risk and passive loss rules when the trust disposes of S stock.

  - **Bank S corporations**

    For tax years beginning after 2004, interest income and dividends on assets required to be held by a bank (as defined in Code Sec. 581), a bank holding company (as defined in section 2(a) of the Bank Holding Company Act of 1956) or a financial holding company (as defined in section 2(p) of that Act) are not treated as passive investment income for purposes of the S corporation passive investment income limits.

- **Relief from inadvertently invalid QSub elections and terminations**

  For elections and terminations after 2004, inadvertent invalid QSub elections and terminations may be waived by IRS.

- **Information returns for Qsubs**

  For tax years beginning after 2004, IRS has authority to provide guidance regarding information returns of Qsubs.

■ **New Reporting Items**

- **Reporting debt discharges**

  For discharges of debt occurring after 2004, there are new rules in regulations for information reporting of discharges of debt by organizations that have a significant trade or business of lending money.

- **Reporting merger discrepancies**

  New Schedule D. Form 941, Report of Discrepancies Caused by Acquisitions, Statutory Mergers, or Consolidations, is used to explain discrepancies for acquisitions, statutory mergers, or consolidations that are effective after December 31, 2004.

- **FUTA**

  For periods ending after December 31, 2004, IRS has issued final regulations that exempt employers from depositing FUTA taxes until their FUTA tax liability exceeds $500.

■ **Changes to Credits**

- **New biodiesel fuels credit**

  For fuel produced and sold or used after December 31, 2004, in tax years ending after that date and before January 1, 2007, a "biodiesel fuels credit" is allowed and is added to the income tax credits treated as a component of the general business credit.

- **Marginal wells**

  Generally for production in tax years beginning after December 31, 2004, there is a new marginal well production credit of $3 per barrel of qualified crude oil production and 50¢¢ per 1,000 cubic feet of qualified natural gas production.

- **Alcohol fuels credit**

  Effective October 22, 2004, the alcohol fuels income tax credit was extended through 2010. For fuel sold or used after December 31, 2004, it is coordinated with the new excise tax credit/refund rules.

- **Enhanced oil recovery (EOR) credit**

  For costs paid or incurred in tax years beginning after 2004, the EOR credit is extended to construction costs of certain Alaska gas treatment plants.

- **Credit for producing electricity**

  Generally for electricity produced and sold after December 31, 2004, the credit rate and credit period are cut in half for electricity produced and sold from certain qualified facilities.

- **Railroad track maintenance**

  For expenditures paid or incurred during tax years beginning after December 31, 2004, and before January 1, 2008, there is a new 50% credit for railroad track maintenance expenditures.

- **Limit on AMT foreign tax credit repealed**

  For tax years beginning after 2004, the 90% limit on the AMT foreign tax credit is repealed.

■ **Changes to Depreciation and Depletion**

- **Bonus depreciation**

  Bonus depreciation generally ended for property placed in service after 2004. Note that under a change made by the 2004 Jobs Act, otherwise qualifying property may be placed in service before January 1, 2006, if it is an aircraft not used in the trade or business of transporting persons or property, except for agricultural or firefighting purposes. At the time of purchase, the buyer must have made a nonrefundable deposit equal to the lesser of 10% of the cost or $100,000, the plane must have an estimated production period exceeding 4 months, and it must cost over $200,000.

- **Percentage depletion**

  For tax years beginning after 2004, the U.S. production activities deduction is disregarded in computing the taxable income limit on the percentage depletion allowance.

- **Timber cutting**

  Outright sales of timber after 2004 qualify for capital gains treatment under Code Sec. 631(b). IRS consent is not required for post-2004 revocations of pre-October 22, 2004, elections to treat timber cutting as a sale or exchange for tax years beginning after 2004.

  > **Observation:** Thus, landowners can get capital gains treatment when they realize gains from sales of timber under Code Sec. 631(b) in situations where those gains wouldn't qualify for capital gains treatment under Code Sec. 1221 (e.g., where the timber is held for sale to customers in the ordinary course of a trade or business) or under Code Sec. 1231 (i.e., where the sale of the timber doesn't qualify as a sale of trade or business property).

  > **Observation:** Gains from an outright sale of timber which qualify for capital gain treatment under Code Sec. 631(b) are excluded from the seller's net earnings from self-employment earnings in the same manner as other capital gains are excluded.

- **Changes for Specialized Entities**

  - **Insurance companies**

    For any tax year beginning after December 31, 2004, and before January 1, 2007, the amount of any direct or indirect distributions to shareholders from a stock life insurance company's existing policyholders surplus account is treated as zero. Thus, the tax imposed on a stock life insurance company for distributions from its policyholders surplus account is suspended for tax years beginning during 2005 and 2006.

    > **Observation:** Thus, for tax years beginning during 2005 and 2006, a stock life insurance company is only subject to income tax on life insurance company taxable income.

  - **RICs**

    Generally with respect to dividends for tax years beginning after 2004, a number of new rules have been added for regulated investment companies.

  - **REMICs**

    Generally effective January 1, 2005, the rules on permitted assets of real estate mortgage investment conduits (REMICs) are changed in a number of respects.

  - **FASITs.** Generally effective January 1, 2005, the rules dealing with financial asset securitization investment trusts (FASITs) are repealed.

- **Foreign Changes**

- **Foreign dividends**

For payments after 2004, dividends paid by a foreign corporation with a minimum 25% effectively connected U.S. income which are treated under Code Sec. 861(a)(2)(B) as income from sources within the U.S. are exempt from the withholding tax on nonresident alien individuals and foreign corporations.

- **Foreign investments**

For tax years of foreign corporations beginning after December 31, 2004, and tax years of U.S. shareholders with or within which such tax years of foreign corporations end, the foreign personal holding company and foreign investment company rules are repealed.

- **Miscellaneous Changes**

- **Environmental remediation**

For gain or loss on disposition of property acquired after 2004, certain brownfield sites are excluded from a tax-exempt organization's debt-financed property under the unrelated business taxable income (UBTI) rules.

- **Withholding on supplemental wages over $1 million**

Employers electing to use the flat rate method of withholding for supplemental wage payments (e.g., bonuses, commissions, and overtime pay) generally withhold at a rate of 25%. However, if a supplemental wage payment made after December 31, 2004, when added to all other supplemental wage payments previously made by the employer to the employee during the calendar year exceeds $1 million, the excess is subject to mandatory withholding at the highest income tax rate in effect for that year, i.e., 35% under current rates.

- **User fees extended**

The use fee program was set to expire for requests made after 2004 but has been extended through September 30, 2014.