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The American Jobs Creation Act of 2004

Congress has finally passed and President Bush signed into law the American Jobs Creation Act of 2004. The centerpiece of the Act is a special new deduction for domestic manufacturing activities designed to lower the effective Federal income tax rate imposed on those activities by approximately 3 percentage points. The new preference for domestic manufacturing activities replaces a set of preferences for export activities of U.S. manufacturers that the World Trade Organization had found to be a prohibited export subsidy.

The Act goes far beyond the original goal of "fixing" the forbidden export subsidy system and enacts a wide range of provisions touching all sorts of activities both within the United States and abroad. Some of the most important changes enacted by the Act are discussed briefly below. We stress, however, that particular taxpayers may find other provisions to be of even greater importance to their own situations.

International Tax

Repeal of ETI Regime

The Act repeals the Extraterritorial Income ("ETI") regime that the World Trade Organization found unacceptable.

Under transition rules, the ETI exclusion is phased out over the 3-year period from 2004 through 2006. The ETI exclusion remains in effect indefinitely for transactions in the ordinary course of a trade or business pursuant to a binding contract between the taxpayer and an unrelated person that is in effect on September 17, 2003, and at all times thereafter.

Foreign corporations that elected to be treated for all federal tax purposes as domestic corporations in order to facilitate the claiming of ETI benefits are allowed to revoke such elections within one year of the date of enactment (October 22) without recognition of gain or loss, subject to anti-abuse rules.

Repatriation of Foreign Earnings

The Act encourages taxpayers to reinvest their foreign earnings into the United States by making certain dividends received by a U.S. corporation from controlled foreign corporations eligible for an 85-percent dividends-received deduction. This deduction is intended to be a temporary economic stimulus measure and is available only for dividends received during a single year: at the taxpayer's election, either its first taxable year beginning on or after the date of enactment (October 22), or its last taxable year beginning before that date. The Conference Report states that there is no intent to make this provision permanent or to extend or re-enact it.

The deduction applies only to cash dividends and certain other cash amounts included in gross income as dividends. It is subject to a number of significant limitations: for example, it applies only to repatriations in excess of the taxpayer's "average repatriation level" over three of the five most recent taxable years. In addition, in order to qualify for the deduction, dividends must be described in a "domestic reinvestment plan" approved by the taxpayer's senior management and board of directors.

No foreign tax credit or deduction is permitted for foreign taxes attributable to the deductible portion of any dividend, and deductions are disallowed for expenses that are properly allocated and apportioned to that portion of a dividend.

Foreign Tax Credit Baskets

Under prior law, the foreign tax credit limitation was calculated separately with respect to nine different categories, or "baskets," of income, including, inter alia, passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, and other ("general") income.

The new provision reduces the number of foreign tax credit baskets to two: passive and general. The financial services basket has been eliminated, but income that would have been treated as financial services income under the old rules will generally be treated as general category income.

This provision is effective for taxable years beginning after December 31, 2006.

Foreign Tax Credit "Base Differences"

Under prior law, when foreign law imposed tax on an item of income that did not constitute income under U.S. tax principles (a "base difference item"), the tax was treated as imposed on income in the "general" basket.

The new provision maintains this rule for taxable years beginning after the reduction to two foreign tax credit baskets takes effect. For taxable years beginning before then, however, taxpayers are permitted to elect whether foreign taxes on base difference items are treated as imposed on income in the "general" basket or income in the "financial services" basket.

Carryforward and Carryback of Foreign Tax Credits

Under prior law, creditable foreign taxes could be carried back two years or forward five years. The new rules limit the carryback to one year but extend the carryforward to ten years. The new carryback period applies to excess foreign taxes arising in taxable years beginning after the date of the enactment (October 22), and the new carryforward rules apply to excess

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foreign taxes that under the old rules could be carried to any taxable year ending after that date.

Look-through Rules for Noncontrolled Section 902 Corporations

Under prior law, the foreign tax credit "10/50" basket included all dividends received by a taxpayer from "10/50 companies" (i.e., foreign corporations in which it owned at least 10 percent of the voting stock but which were not controlled foreign corporations) that were paid out of earnings and profits accumulated in taxable years beginning before January 1, 2003. Dividends paid by 10/50 companies out of E&P accumulated in later taxable years were categorized into foreign tax credit baskets in proportion to the ratio of the paying company's earnings and profits attributable to income in each such basket (a "look-through" approach).

The new provision applies a look-through approach to all dividends paid by 10/50 companies, regardless of when the earnings and profits out of which the dividends are paid were accumulated. The provision is effective for taxable years beginning after December 31, 2002.

Attribution of Stock Ownership Through Partnerships

Under sections 902 and 960, a domestic corporation that receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock, or that has a subpart F inclusion from a controlled foreign corporation in which it is a U.S. shareholder (i.e., owns 10 percent or more of the voting stock), is deemed to have paid a portion of the foreign taxes paid by the foreign corporation and may claim a foreign tax credit with respect to such deemed-paid taxes.

It has never been entirely clear whether voting stock held through a partnership should be attributed to domestic corporations for purposes of determining whether the 10 percent voting stock ownership threshold for the deemed-paid foreign tax credit is met. Also uncertain under the old rules was whether a corporation could claim a direct foreign tax credit for its proportionate share of taxes paid by a partnership in which the corporation was a partner.

The new rule clarifies that a domestic corporation that owns 10 percent or more of the voting stock of a foreign corporation indirectly through a foreign or domestic partnership may claim deemed-paid foreign tax credits for taxes paid by the foreign corporation. It also clarifies that corporate partners may claim a direct foreign tax credit for their proportionate shares of taxes paid or accrued by a partnership.

The provisions apply to taxable years beginning after the date of enactment (October 22).

Dividends Paid by Foreign Corporations with U.S. Trades or Businesses

Dividends paid by a foreign corporation generally are treated as foreign source income unless more than 25 percent of the corporation's gross income is effectively connected with the conduct of a trade or business in the United States ("ECI"). In that case, a portion of the dividend is treated as U.S. source income. Under prior law, the U.S. source portion of the dividend was subject to 30 percent gross basis U.S. tax.

The new rule eliminates the 30 percent tax on U.S. source dividends paid by foreign corporations.

Sourcing of Interest Paid by Foreign Partnerships

Under current regulations, all interest paid by a foreign partnership engaged in a trade or business in the United States is treated as U.S. source income. By contrast, interest paid by foreign corporations is generally treated as foreign source income, even if the corporation is engaged in a U.S. trade or business, except to the extent the interest is paid by the U.S. trade or business.

The new rule attempts to conform the treatment of foreign partnerships to that of foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S. source income only if it is paid by a U.S. trade or business of the partnership or allocable to effectively connected income of the partnership.

This provision applies only to partnerships that are "predominantly engaged" in the active conduct of a trade or business outside the United States. Interest paid by partnerships whose predominant business is in the United States continues to be treated as U.S. source income in its entirety.

The new rule is effective for taxable years beginning after December 31, 2003.

Repeal of FPHC and FIC Rules

For many years the Code has included a variety of overlapping anti-deferral rules, including subpart F (sections 951-964), the passive foreign investment company ("PFIC") rules (sections 1291-1298), the foreign personal holding company ("FPHC") rules (sections 551-558), the personal holding company ("PHC") rules (sections 531-537), and the foreign investment company ("FIC") rules (sections 1246-1247).

The Act eliminates the FPHC and FIC rules and makes clear that foreign corporations are excluded from the application of the PHC rules. However, personal services contract income that was subject to the FPHC rules is now treated as foreign personal holding company income under section 954 and therefore as subpart F income.

The amendments are generally effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

Overall Domestic Losses

If a taxpayer's losses from foreign sources exceed its foreign source income, the resulting "overall foreign loss" ("OFL") could be used to offset U.S. source income for foreign tax credit purposes, thus reducing the effective rate of U.S. tax on such income. To prevent this, the foreign tax credit provisions of the Code contain special OFL recapture provisions under which a portion (but no more than 50 percent) of foreign source income earned in the taxable year after an OFL year is recharacterized as U.S. source income for foreign tax credit purposes. This has the effect of reducing the foreign tax credit limitation and thus the amount of U.S. tax that can be offset by foreign tax credits.

The Act provides an analogous rule for overall domestic losses ("ODLs") – i.e., domestic losses that offset foreign source taxable income for foreign tax credit purposes and thus reduce a taxpayer's foreign tax credit limitation. Under the new provision, a portion (but no more than 50 percent) of the taxpayer's U.S. source

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income for the year after an ODL year is recharacterized as foreign source income. This section applies to losses for taxable years beginning after December 31, 2006.

Interest Expense Allocation

In order to compute its foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. This requires deductions and expenses to be allocated and apportioned between U.S. and foreign source gross income.

Interest generally is allocated between U.S. and foreign source gross income based on the relative value of the taxpayer's assets that produce income in each category. For this purpose, all domestic members of an affiliated group of corporations generally are treated as a single corporation but foreign members of the group are not included in the unified group.

Under the new rules, a taxpayer with a worldwide group of affiliated corporations may elect to determine the foreign source taxable income of the domestic members of the group by allocating and apportioning the interest expense of those members as if all members of the worldwide group, including the foreign members, were a single corporation. The common parent of the worldwide group must make the election.

There are special rules for financial institutions.

For more information, please contact Jessica Katz at (202) 862-5027 or jlk@capdale.com.

Deferred Compensation

The Act will impose significant restrictions on deferred compensation. The new rules generally apply to amounts deferred after December 31, 2004. However, amounts deferred before January 1, 2005 will lose their grandfathered status in the event of a "material modification" made after October 3, 2004.

New section 409A of the Code will broadly apply to any plan that provides for the deferral of compensation other than a "qualified employer plan" or a bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan includes any section 401(a) or 403(a) retirement plan, a section 403(b) plan, a SEP, a SIMPLE, a section 501(c)(18) trust, a section 457(b) plan, or a section 415(m) governmental excess benefit arrangement. SERPs, LTIPs, executive pensions, severance-pay plans, and section 457(f) plans are subject to the new rules, whether they are defined-benefit or defined-contribution plans and whether they are maintained by corporations, tax-exempt organizations, or governmental entities.

The legislative history indicates that the new rules do not apply to statutory stock options or non-statutory stock options issued at the money; however, so-called "discounted" stock options appear to be covered by the legislation. Additionally, it appears that stock appreciation rights and other forms of equity-based deferred compensation are subject to the new rules, at least until the Treasury Department provides otherwise through administrative guidance. The payment of annual bonuses within 2½ months after the end of the taxable year will not be treated as a deferred compensation plan (although any arrangement to defer the receipt of such bonuses will be considered deferred compensation). The status of split-dollar life insurance is unclear.

The new rules regulate three aspects of deferred compensation – initial deferral elections, holding of assets, and distribution of benefits:

Initial Deferral Elections

Any election to defer compensation generally must be made no later than the end of the taxable year before the compensation is earned (although the Treasury Department can provide for a different election-timing rule by regulation). Any newly eligible participant will have a 30-day grace period for the initial deferral election.

An election to defer "performance-based compensation" earned over a period of at least one year must be made no later than six months before the end of that period.

Holding of Assets

A company cannot secure its deferred compensation obligations by holding assets offshore in a trust or other arrangement designated by the Treasury Department. This provision was intended to prohibit offshore rabbi trusts, but it gives the Treasury power to extend its reach much farther.

A company will not be permitted to restrict creditor access to assets in the event of a change in the company's financial health. This applies even if the change in financial health simply triggers funding through a rabbi trust.

Distribution of Benefits

A plan cannot pay out deferred compensation to participants other than on separation from service, disability, death, a change of control, an unforeseeable emergency, or at a time or under a schedule pre-specified under the plan. Key employees of public companies will have to wait six months after separation from service before receiving any distributions. No distributions are permitted on a change of control until the Treasury Department issues guidance defining that term.

An election by a participant to defer a scheduled distribution (a so-called "second election") generally must be made at least twelve months in advance and in most cases must push the distribution off by at least five years.

Subject to exceptions created by the Treasury Department, a plan may not accelerate the time or schedule of any payment of deferred compensation. This is intended to prohibit "haircut" distributions but will also restrict changes in distribution form (for example, an election to change from an annuity or installments to a lump sum or from an annuity to a shorter period of installments).

If a deferred compensation plan fails any of the new rules, each affected participant in the plan will have to pay tax on all his or her vested deferred compensation, along with any accrued earnings – plus interest and a 20-percent penalty tax.

The new rules will apply to deferred compensation plans that cover groups of participants or only a single participant. They apply to arrangements covering employees, directors, and independent contractors. The legislation also imposes W-2 and 1099 reporting requirements to

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show annual deferral amounts, although it seems likely that the required reporting will be similar to what is currently required for FICA purposes. Any amount includible under these rules for a participant will be subject to federal income tax withholding. Apart from the reporting and withholding obligations, there is no change in the treatment of the employer or other payor of deferred compensation. For example, a corporation will still be able to deduct deferred compensation at the time it is includible in an employee's income.

The new rules generally will apply to amounts deferred after December 31, 2004. Amounts deferred and vested before January 1, 2005 and any future earnings on those amounts are grandfathered unless a plan is "materially modified" after October 3, 2004. The legislative history indicates that adding or enlarging participant rights and options under a plan will result in material modifications but that narrowing or eliminating participant rights and options will not. Any new plan established after October 3, 2004 allowing for new deferrals before December 31, 2004 would not qualify for the grandfather rule.

The new rules will require administrative guidance from the Treasury Department on a wide variety of issues and questions. The legislation specifically directs the Treasury Department to issue guidance within 60 days to give companies a limited window to amend their deferred compensation plans to conform to the new rules. The legislative history indicates that the Treasury Department should give taxpayers a reasonable time to make necessary plan amendments after that guidance is issued. Guidance is also required from the Treasury Department within 60 days to allow participants a limited window to cancel an outstanding deferral election and within 90 days to define what constitutes a permissible change of control for triggering distributions.

The reach of the new legislation is very broad, and the tax consequences for participants covered by plans that fail the new rules are serious. Therefore, taxpayers should immediately initiate a review of all their deferred compensation arrangements to determine what actions should be taken in response to the new legislation – including not only formal deferred compensation plans but also any individual employment, consulting, or other service contracts that provide for any kind of deferred compensation.

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Tax Shelter Reform

The Act puts in place tax shelter reform legislation that has been proposed since 2000 by both the Clinton and Bush Administrations. Aside from shutting down perceived substantive loopholes that have been exploited in various known abusive transactions over the past few years, the legislation substantially revised the tax shelter reporting regime – the "web of disclosure" in tax shelter registration, list maintenance, and taxpayer reporting. These changed both in substance and in the penalties attached to them.

The legislation generally builds on the reporting regime for taxpayers that Treasury and the IRS had already put in place under the authority of section 6011. The former "registration" provision, section 6111, was revised to require returns "disclosing" the set of "reportable transactions" and the subset of "listed transactions" defined under section 6011. Section 6112, the "list maintenance" provision, also now tracks this regime by statute, as well as by the regulations (as it previously did). The penalties for noncompliance with these provisions were also clarified and substantially increased, and although the Commissioner was given authority to "rescind" penalties that authority is not expected to be used much.

There are two significant issues that practitioners and taxpayers should be aware of. First, the definition of a "material advisor," who now has disclosure (registration) as well as list maintenance obligations, does not track precisely the use of that term under the existing section 6112 regulations. Second, under the effective date provision for these changes, they apply immediately, even though Treasury and the IRS have not promulgated revised forms and regulations to accommodate them.

Additional penalties were also added at the taxpayer level. The legislation provides a large new penalty (section 6707A) targeted exclusively at failure by taxpayers to disclose reportable (and "listed") transactions with their returns. The substantial understatement penalty was also considerably revised to discourage non-compliance with the shelter reporting regime. Although penalties can still be waived for "reasonable cause," taxpayers can no longer show it by relying on certain kinds of tax opinions or tax advisors. Congress even eliminated the deductibility of interest with respect to shelter-related tax underpayments that are not disclosed, and extended the statute of limitations for assessments with respect to transactions that should have been disclosed but weren't.

A number of other changes addressed Circular 230, injunctive actions against promoters, and a variety of specific abuses.

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