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## American Jobs Creation Act of 2004

### I. Outline

Congress recently passed the American Jobs Creation Act of 2004 (the "Act"), which was signed by the President on October 22, 2004.

Some of the key relief provisions of the Act include a temporary incentive for U.S. multinationals to repatriate foreign earnings, a domestic manufacturing deduction, and international tax reforms designated to improve the global competitiveness of U.S. businesses. The tax relief is offset by a number of revenue-raising provisions, including the repeal of a U.S. export tax incentive known as the extraterritorial income exclusion, new tax shelter penalties, restrictions on deferred compensation, and numerous other provision aimed at specific types of transaction such as tax-exempt leasing and patent donations.

This article will summarize the following:

1. Extraterritorial Income (ETI) repeal
2. Domestic manufacturing deduction
3. Foreign repatriation
4. Foreign tax credit reform
5. CFC subpart F income reform
6. Penalties for failing to disclose certain reportable issues
7. Others
  - (1) Leasehold improvements and restaurants property
  - (2) Small business expensing
  - (3) Amortization of start-up and organizational expenditures

### II. ETI repeal

The Act repeals the extraterritorial income (ETI) exclusion for transactions after 2004 with two years of transition relief (2005-2006). The Act also grandfathers transactions under binding contracts with unrelated persons entered into before September 18, 2003. Foreign corporations that have elected to be treated as domestic corporations for purposes of the ETI exclusion generally are permitted to revoke those elections without adverse tax consequences.

During the transition period, the Act provides a deduction equal to the following percentages of the amounts that otherwise would have been (1) excludable from the gross income of the corporation under the ETI exclusion or (2) treated as exempt foreign trade income of related foreign sales corporations for transactions during the following years:

<u>Year</u>	<u>Percentage deduction</u>
2005	80%
2006	60%
2007 and thereafter	0%

### III. Domestic manufacturing deduction

#### 1. Outline

The Act provides a nine-percent deduction for income from domestic production activities, phased in over six years (2005-2010). The deduction is available to all corporations, partnerships, sole proprietorships, cooperatives, and estates and trusts with qualifying production activities income. The deduction is calculated on the lesser of income from domestic production activities or taxable income of the taxpayer. The deduction reduces income for purposes of computing both regular and alternative minimum taxable income.

#### 2. Calculation of qualified production activities deduction

Qualified production activities income is calculated as:

\* Domestic production gross receipts

Less:

\* Allocable cost of goods sold;

\* Directly allocable deductions; and

\* Ratable allocation of other deductions not directly allocable to another class of income.

#### 3. Qualifying activities

The Act provides a broad definition of what qualifies as production activities eligible for the deduction. Qualified production activities include income from the license, lease, rental, sale, exchange or other disposition of:

- Any tangible personal property, computer software, and sound recording which is manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States;
- Motion pictures and television productions if more than 50 percent of the total

compensation for services is performed in the United States;

- Electricity, natural gas or portable water produced in the United States;
- Construction performed in the United States; and
- Engineering or architectural services performed in the United States for construction projects in the United States.

Although food processors generally qualify, income derived from the sale of food or beverages prepared by the taxpayer at a retail establishment does not qualify. In addition, income from the transmission or distribution of electricity, natural gas, or portable water does not qualify. Also, income derived from property that is leased, licensed, or rented by the taxpayer for the ultimate use by a related person does not qualify.

#### 4. Amount of deduction for domestic production activities income

Year	Percentage deduction
2005-2006	3%
2007-2009	6%
2010 thereafter	9%

#### 5. Computation of allowable deduction

In general, the allowable deduction is equal to three percent (six and nine percent in subsequent years) of a taxpayer's gross receipts from qualifying activities reduced by the allocable cost of goods sold, deductions that are directly allocable to such receipts (e.g., marketing and advertising expenses), and a ratable share of other deductions not related to another category of income (e.g., corporate general and administrative expenses relating to advertising). The amount of income on which the deduction is calculated cannot exceed the taxpayer's taxable income. In addition, another limitation, with likely limited applicability, limits the deduction to 50 percent of annual wages paid by the taxpayer.

#### 6. Affiliated groups and pass-through entities

In the case of corporate taxpayers that are members of an expanded affiliated group (using a 50-percent control test), the deduction is determined by treating all members of such groups as a single taxpayer. The deduction is allocated among such members in proportion to each member's respective amount (if any) of qualified production activities income.

With respect to domestic production activities of an S corporation, partnership, or other

pass-through entity, the deduction generally is determined at the shareholder, partner, or similar level with each partner or shareholder reporting its proportionate share of the entity's qualified production activities income.

The provision is effective for taxable years beginning after 2004.

#### **IV. Foreign repatriation**

##### **1. Outline**

The Act creates a temporary incentive for U.S. companies to repatriate accumulated foreign earnings by providing an elective 85-percent dividends received deduction for certain dividends from controlled foreign corporations. The provision is effective either for the last taxable year beginning before the date of enactment, i.e., October 22, 2004 (2004, for calendar-year taxpayers) or the first taxable year beginning during the one-year period starting on the date of enactment (2005, for calendar-year taxpayers).

##### **2. Eligible dividends**

To be eligible for the new dividends received deduction, dividends must be paid in cash. This leaves certain types of deemed dividends ineligible for the benefit, including most deemed income inclusions under the so-called subpart F anti-deferral rules relating to certain undistributed income of controlled foreign corporations, investment in U.S. property by controlled foreign corporations, and gain treated as dividend on the disposition of controlled foreign corporation stock. However, to enable foreign earnings of lower-tier foreign subsidiaries to qualify for the benefit, the Act permits the payment of dividends up a chain of controlled foreign corporations to qualify, provided the income is repatriated to the United States before the close of the election period.

##### **3. Limitations**

The new deduction is subject to a number of limitations.

First, the dividends must be invested in the United States under a domestic reinvestment plan approved by company management. The chief executive officer or comparable official must approve the plan before the dividend is paid. Board of director's approval also is required, but is not necessary until the close of the election year. The provision contains a non-exclusive list of examples of permitted uses of the funds: funding of worker hiring and training; infrastructure; research and development; capital investments; and the financial stabilization of the corporation for purposes of job retention and creation.

Second, the dividends must exceed the average repatriation level from all controlled foreign corporations over a five-year base period. The base period is the five most recent tax years of the U.S. company ending on or before June 30, 2003 (i.e., 1998 through 2002, for calendar-year taxpayers). The two tax years in this five-year period with the highest and lowest repatriation amounts are disregarded in computing the base period average. The types of repatriations included in computing the base period average are more diverse than the types of repatriations eligible for the dividends received deduction. Specifically, repatriations taken into account in computing the base period average include amounts that were required to be included in income as a result of investments in U.S. property and the repatriation of previously taxed income relating to deemed income inclusions under the subpart F anti-deferral rules. Also, repatriations need not be in cash to be counted in determining the base period average.

Third, the deduction is limited to the greater of: (1) \$500 million, (2) the earnings reported on the company's financial statement as permanently reinvested outside the United States, or (3) in the case of a financial statement that fails to show such an earnings amount and which shows a specific amount of U.S. tax liability attributable to such earnings, the amount of such tax liability divided by 35 percent. The financial statements referred to in both (2) and (3) must have been certified on or before June 30, 2003, as having been prepared in accordance with U.S. generally accepted accounting principles.

## **V. Foreign tax credit**

### **1. Interest expense allocation reform**

The Act replaces the present-law method of interest expense allocation with a worldwide fungibility approach. The Act provides a one-time election to allocate and apportion third-party interest expense of U.S. members of a worldwide affiliated group to foreign-source income for foreign tax credit limitation purposes in an amount equal to the excess, if any, of: (1) the worldwide affiliated group's interest expense multiplied by a fraction representing the group's foreign assets over its worldwide assets, over (2) third-party interest expense incurred by foreign members of the group that would otherwise be allocated to foreign sources.

### **2. Foreign tax credit carryover period**

The Act extends the foreign tax credit carryforward period from five to 10 years, and reduces the carryback period from two years to one year.

3. Limitation on AMT foreign tax credit

The Act eliminates the 90-percent limitation on the use of foreign tax credits against the alternative minimum tax.

4. Foreign tax credit limitation baskets

The Act reduces the current nine foreign tax credit baskets to two: a general basket and a passive basket. Income in the current baskets are assigned to one of these two baskets as appropriate.

5. Recharacterization of overall domestic loss

The Act applies a re-sourcing rule to U.S.-source income where a taxpayer's foreign tax credit limitation has been reduced as a result of an overall domestic loss. Under the Act, a portion of the taxpayer's U.S.-source income for each succeeding taxable year is recharacterized as a foreign-source income in an amount equal to the lesser of : (1) the amount of the uncharacterized overall domestic losses for years prior to such succeeding taxable year, or (2) 50 percent of the taxpayer's U.S.-source income for such succeeding taxable year.

**VI. CFC subpart F income reform**

1. Sales of partnership interests

The Act treats the sale by a controlled foreign corporation of a 25-percent or greater partnership interest as a sale of the proportionate share of partnership assets for purposes of determining whether gain from such sale gives rise to subpart F foreign personal holding company income.

2. Repeal of certain anti-deferral regimes

The Act repeals the foreign personal holding company rules and foreign investment company rules. In addition, the Act excludes foreign corporations from the personal holding company rules, and includes personal services contract income targeted under the present-law foreign personal holding company rules as subpart F income.

**VII. Tax shelters**

1. Penalties for failing to disclose certain reportable transactions

The Act imposes new penalties on all taxpayers who fail to disclose reportable transactions. For listed transactions, the penalty amount is \$200,000 (\$100,000 for natural persons); for other reportable transactions, the penalty is \$50,000 (\$10,000 for natural persons).

The penalties apply whenever a taxpayer fails to make a required disclosure, regardless of

whether the IRS was aware of (or had audited) the transaction or whether the taxpayer's position on the merits is sustained. Moreover, no penalty imposed with respect to a listed transaction can be waived under any circumstances. The IRS has limited authority to rescind penalties with respect to other reportable transactions (and must report any waivers to Congress).

## 2. New accuracy-related penalty

The Act provides a new accuracy-related penalty applicable to understatements attributable to "reportable avoidance transactions," defined to include listed transactions and reportable transactions with a significant tax avoidance purpose. The rate of this new penalty and available defenses depend on whether the taxpayer adequately disclosed the transaction.

## 3. SEC disclosure of certain penalties

The Act requires taxpayers to disclose certain penalties in SEC filings. Under the Act, any entity required to file reports with the SEC must disclose:

- Any penalty imposed for failure to disclose a listed transaction;
- Any accuracy-related penalties imposed at a 30-percent rate with respect to a non-disclosed listed or reportable avoidance transaction; and
- Any penalty for gross valuation misstatements attributable to a non-disclosed listed transaction or non-disclosed reportable avoidance transaction.

The failure to make any required SEC disclosure is treated as a separate failure to disclose a listed transaction and subject to an additional penalty of \$200,000.

## 4. Expanded statute of limitations for non-disclosed listed transactions

The Act extends the statute of limitations for any listed transaction that a taxpayer fails to disclose on a timely basis. The Act extends the statute, solely with respect to the listed transaction, until one year after the date on which the transaction is disclosed to the IRS, either by the taxpayer or by a material advisor. Thus, if the listed transaction is not disclosed, the statute of limitations for that transaction could remain open indefinitely.

## VIII. Others

### 1. Leasehold improvements and restaurants property

The Act reduces the current recovery period for qualified leasehold improvements and restaurant property from 39 years to 15 years.

The provision is effective for qualified leasehold and restaurant improvements placed in service

after the date of enactment and before January 1, 2006.

2. Small business expensing

The Act extends for two additional years the \$100,000 deduction for certain depreciable assets. The allowable deduction will revert to \$25,000 beginning in 2008. This two-year extension also applies to inflation adjustments permitted under current law and to the expanded definition of qualifying property to include off—the-shelf software placed in service in taxable years beginning before 2008.

3. Amortization of start-up and organizational expenditures

The Act provides for a 15-year amortization period for start-up costs and the organization costs of a corporation or partnership. Under present-law, such costs are amortizable over a period of not less than 60 months.

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