ESOP Repayment of S Corporation Loan

I.R.C. §4975(f); Act §240
Effective for distributions made after December 31, 1997

Background
An employee stock ownership plan (an ESOP) is a defined contribution plan that invests primarily in qualifying employer securities (generally, common stock of the employer or a member of the same controlled group). Effective for taxable years beginning after December 31, 1997, a qualified retirement plan (including an ESOP) may be a shareholder of an S corporation. As a result, an S corporation may maintain an ESOP.

Prohibited transactions between an employee benefit plan and a disqualified person (including the employer maintaining the plan) result in the imposition of an excise tax. They include the sale of property between a plan and a disqualified person and the lending of money or other extension of credit between a plan and a disqualified person. However, certain loans to enable an ESOP to purchase qualifying employer securities are exempt from the prohibited transaction rules. Dividends paid by a C corporation on the employer securities held by the ESOP may be used to repay the loan.

New Law
The Jobs Act of 2004 provides that an ESOP maintained by an S corporation may use distributions from the S corporation to repay a loan (interest and principal) from the S corporation that was used to acquire the S corporation stock. If the stock had been allocated to a participant’s
account, the plan must provide that employer securities with a fair market value (FMV) at least equal to the distribution will be allocated to the participant’s account for the year of the distribution.

Foreign Tax Credit for Transfers of Intangibles
I.R.C. §367(d)(2); Act §406
Effective for amounts received on or after August 5, 1997

Background
When intangible property is transferred to foreign corporations through nonrecognition transactions, special rules mitigate the tax avoidance that may arise from shifting the income attributable to intangible property offshore. Under I.R.C. §367(d), the outbound transfer is treated as a sale of the intangible for a stream of contingent payments commensurate with the foreign corporation’s income attributable to the intangible. The Taxpayer Relief Act of 1997 repealed a rule that treated the deemed payments as U.S.-source income. As a result, general sourcing rules apply. These treat income from sales of intangible property for contingent payments as royalties, which can be foreign-source income. The 1997 Act did not address the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories (I.R.C. §904).

New Law
The Jobs Act of 2004 provides that the payments are treated as royalties for the separate limitation categories of the foreign tax credit.

Involuntary Conversion of Livestock
I.R.C. §§451(e) and 1033(e); Act §311
Effective for tax years for which the return is due after December 31, 2002 (not including extensions).

Background
There are two rules in the Internal Revenue Code that allow owners of livestock to postpone recognizing gain from the sale of livestock if the sale was caused by weather conditions such as droughts, floods or hail storms.

Involuntary Conversion
I.R.C. §1033(e) allows taxpayers to treat the sale of livestock (other than poultry) that is held for draft, breeding, or dairy (not sporting) purposes in excess of the number of livestock that would have been sold but for drought, flood, or other weather-related conditions as an involuntary conversion. Consequently, gain from the sale of such livestock can be deferred by reinvesting the proceeds of the sale in similar property within a two-year period. The livestock must be replaced with livestock that are similar in use to the converted livestock. For example, dairy cows cannot be replaced with beef cows.

One-Year Postponement
I.R.C. §451(e) allows a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought, flood, or other weather-related conditions to elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer’s usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in an area being designated as eligible for federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the weather-related condition.

Practitioner Note—Disaster Area Declaration Is Not Required. This provision does not require an area to be declared a disaster area.

Practitioner Note—All Livestock Qualifies. Unlike the involuntary conversion provision, this provision is not limited to livestock held for draft, breeding or dairy purposes. Gain from livestock held for resale or held for sporting purposes also qualifies.
Taxpayers must make the I.R.C. §451(e) election by the extended due date of the return for the year the livestock is sold.

**New Law**

**Involuntary Conversion**
The Jobs Act of 2004 extends the applicable period for a taxpayer to replace livestock sold on account of drought, flood, or other weather-related conditions from 2 years to 4 years after the close of the first taxable year in which any part of the gain on conversion is realized. The extension is only available if the taxpayer establishes that, under the taxpayer’s usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for federal assistance. In addition, the Secretary of the Treasury is granted authority to further extend the replacement period on a regional basis should the weather-related conditions continue longer than 3 years.

The Jobs Act of 2004 also permits the taxpayer to replace compulsorily or involuntarily converted livestock with other farm property if, due to drought, flood, or other weather-related conditions, it is not feasible for the taxpayer to reinvest the proceeds in property similar or related in use to the converted livestock.

**Example 1. Not Feasible to Replace with Similar-Use Property**

A tornado blew down Guy Wire’s dairy parlor in 2002. The storm did not result in a disaster area declaration but Guy was forced to sell his dairy cows because he had no facilities to milk them. On his 2002 tax return, Guy elected to postpone the gain by rolling it over to replacement property. Guy was unable to get building permits to rebuild his dairy facilities so he used the proceeds from the sale of his dairy cows to buy beef cows in November 2004.

The beef cows are qualified replacement property because it was not feasible for Guy to replace his dairy cows with dairy cows.

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**Observation—Disaster Area Requirement.** Unlike the provision that extends the replacement period to 4 years, the provision that expands the definition of replacement property to any farm property does not require a disaster area declaration.

**Observation—Only Draft, Breeding or Dairy Livestock.** The extended period for making the I.R.C. §451(e) election is available only for draft, breeding or dairy livestock because other livestock is not eligible for the involuntary conversion rules.

**One-Year Postponement**
The period for electing to defer income for 1 year (under I.R.C. §451(e)) is extended for property that is eligible for the 4-year replacement period under the involuntary conversion rules of I.R.C. §1033(e). The election can be made until the 4-year replacement period for the converted property expires.

**Look-Through Rules for Foreign Tax Credit**

I.R.C. §904(d)(4); Act §403
Effective for taxable years beginning after December 31, 2002

**Background**

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10% of the stock by vote and which is not a controlled foreign corporation (a so-called 10/50 company). A look-through rule applies only to dividends paid from earnings and profits accumulated by the 10/50 company in tax years beginning after December 31, 2002.

**New Law**
The Jobs Act of 2004 simplifies the rules by providing that the look-through approach applies to dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, regardless of the year in which the earnings and profits paid out were accumulated.
The dividends are treated as income in each foreign tax credit limitation category in proportion to the ratio of the company’s earnings and profits attributable to income in that foreign tax credit limitation category to its total earnings and profits.

**Affirmation of Consolidated Return Regulation Authority**

I.R.C. §1502; Act §844
Effective for tax years beginning before on, or after October 22, 2004

**Background**

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. I.R.C. §1502 specifically provides for consolidated return regulations. In Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001), the Federal Circuit Court of Appeals concluded that a duplicated loss provision of the regulations was invalid. The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a different result for a consolidated return than if the corporations had filed separate returns. The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision.

**New Law**

The Jobs Act of 2004 provides that in exercising authority under I.R.C. §1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

- Treasury is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as it deems necessary to determine and adjust the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, to clearly reflect the income-tax liability and prevent avoidance of such liability.

- The Rite Aid holding is overruled to the extent it suggests that Treasury is required to identify a problem created from the filing of consolidated returns in order to issue regulations that change the application of an I.R.C. provision.

- Nevertheless, the Rite Aid result stands with respect to the factual situation presented in the case, overriding the regulation that denied a loss on a deconsolidating disposition of stock of a consolidated subsidiary to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.

- Retaining the result with respect to Treas. Reg. §1.1502-20(c)(1)(iii) does not prevent or invalidate the various approaches Treasury has announced it will apply or intends to consider in lieu of the approach of that regulation. This includes, as examples, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.

**Nonqualified Preferred Stock**

I.R.C. §351(g)(3)(A); Act §899
Effective for transactions after May 14, 2003

**New Law**

IRC §§351, 354, 355, 356, and 1036 treat nonqualified preferred stock as boot in corporate transactions, subject to certain exceptions. The definition of nonqualified preferred stock is clarified to ensure that it includes stock for which there is not a real and meaningful likelihood of actually participating in the earnings and profits of the corporation.

**Renewal Communities Designation**

I.R.C. §§45D, 1400E; Act §§222, 223
Effective as if included in Community Renewal Tax Relief Act of 2000

**Background**

The Community Renewal Tax Relief Act of 2000 provided that 1990 census data would be
used to determine areas eligible for designation as renewal communities. Special tax incentives available to businesses in those areas include an expanded I.R.C. §179 deduction, an employment tax credit, a commercial revitalization deduction and a capital gain exclusion.

New Law
The Jobs Act of 2004 provides that renewal communities designated using the 1990 census may be expanded using year 2000 census data. In addition, the low-income test for high migration rural counties is modified to use 85% (rather than 80%) of statewide median family income. A high migration rural county is any county that, during the 20-year period ending with the census year, has a net out-migration of at least 10% of the population of the county at the beginning of the 20 years.

Real Estate Investment Trusts
I.R.C. §856; Act §243
Effective generally for taxable years beginning after December 31, 2000.

New Law
The Jobs Act of 2004 makes several modifications to the REIT rules as follows.

- Modifies the definition of “straight debt,” for purposes of the limitation that a REIT may not hold more than 10% of the value of the outstanding securities of a single issuer, to provide more flexibility than prior law.
- Provides specific safe-harbor rules regarding the dates for testing whether 90% of a REIT property is rented to unrelated persons and whether the rents paid by related persons are substantially comparable to unrelated party rents.
- Prospectively eliminates the safe harbor allowing rents received by a REIT to be exempt from the 100% excise tax if the rents are for customary services performed by a taxable REIT subsidiary (TRS) or are from a TRS and are described in I.R.C. §512(b)(3).
- Conform the rules governing the tax treatment of arrangements engaged in by a REIT to reduce certain interest rate risks to the rules included in I.R.C. §1221.
- Prospectively amends the tax liability owed by the REIT when it fails to meet the 95% of gross income test by applying a taxable fraction based on 95%, rather than 90%, of the REIT’s gross income.

Some of the provisions are effective for taxable years beginning after October 22, 2004. These are: the new “look through” rules determining a REIT partner’s share of partnership securities for purposes of the “straight debt” rules; the provision changing the 90% of gross income reference to 95%, for purposes of the tax liability if a REIT fails to meet the 95% of gross income test; the new hedging definition; the rule modifying the treatment of rents with respect to customary services; and the new rules for correction of certain failures to satisfy the REIT requirements.

Corporate Inversion Transactions
I.R.C. §7874, Act §801
Effective for taxable years ending after March 4, 2003

Background
The United States employs a worldwide tax system under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is effectively connected with the conduct of a trade or business in the United States. A U.S. corporation may reincorporate in a foreign jurisdiction to remove foreign operations from the U.S. taxing jurisdiction. These transactions, commonly referred to as inversion transactions, may give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level.

In a stock inversion, the U.S. corporation’s shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. The U.S. shareholders generally recognize gain (but not loss) under I.R.C. §367(a), based on the difference between the FMV of the foreign corporation shares received and their
adjusted basis of the domestic corporation stock exchanged.

**New Law**


- Intended tax benefits of an inversion are denied by deeming a top-tier foreign corporation to be a domestic corporation for all purposes of the I.R.C. This applies when (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or transfers substantially all of its property to a foreign entity; (2) the former shareholders of the U.S. corporation afterwards hold 80% or more (by vote or value) of the stock of the foreign-incorporated entity; and (3) the foreign-incorporated entity (including members of its affiliated group, using a more than 50% ownership factor) does not have substantial business activities in its country of incorporation, compared to the total worldwide business activities of its expanded affiliated group.

- Some transactions would meet the definition of an inversion transaction except that the 80% ownership threshold is not met. If at least a 60% ownership threshold is met, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level income or taxes for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. These measures generally apply for a 10-year period following the inversion transaction.

- Inversion transactions include partnership transactions when a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60% of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. The tax attribute rules apply at the partner level.

- A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired (directly or indirectly) more than half of the properties held (directly or indirectly) by the domestic corporation, or more than half of the properties constituting the partnership trade or business.

**Insider Stock Transactions**

I.R.C. §4985; Act §802

**Background**

Shareholders are generally required to recognize gain upon stock inversion transactions. An inversion transaction is generally not a taxable event for holders of stock options and other stock-based compensation.

**New Law**

The Jobs Act of 2004 adds I.R.C. §4985, which imposes an excise tax on disqualified individuals who hold stock options or rights to other stock-based compensation during a 12-month period beginning six months before the date a corporation expatriates.

- The excise tax is equal to the maximum rate of tax on individual net capital gains (15% for 2005 through 2008 and 20% for taxable years beginning after 2008).

- Disqualified individuals generally include officers, directors, and 10% or greater owners of private and publicly held corporations. The excise tax is imposed only if gain is recognized in whole or part by any shareholder by reason of a corporate inversion transaction.

- All restrictions on the stock compensation, other than a non-lapse restriction, are ignored. Thus, the excise tax applies without regard to whether the stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the inversion transaction.
- Specified stock compensation does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, tax-sheltered annuity, simplified employee pension, or SIMPLE.
- In addition, the excise tax does not apply to any stock option that is exercised during the 6-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under IRC §83 on or before the expatriation date with respect to the acquired stock. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed out, or otherwise paid during that period in a transaction in which income, gain, or loss is recognized in full.

**Effective for Tax Years Beginning in 2004**

**Deductions of General Sales Taxes**

I.R.C. §164(b)(5); Act §501

**Effective for tax years beginning after December 31, 2003**

**Background**

An itemized deduction is permitted for certain state and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. No itemized deduction has been permitted for state or local general sales taxes since 1986.

**New Law**

IRC §164 is amended to permit taxpayers to choose to deduct state and local general sales and use taxes in lieu of state and local income taxes, effective for tax years beginning after 2003 and before 2006. Taxpayers will have two options for determining the sales tax deduction amount.

1. They may deduct the total amount of general state and local sales taxes paid by accumulating receipts showing general sales taxes paid.
2. They may use tables printed in IRS instructions. The tables are based on average consumption on a state-by-state basis, taking into account filing status, number of dependents, adjusted gross income and rates of state and local general sales taxes. Those who use the tables may, in addition to the table amounts, deduct eligible general sales taxes paid for the purchase of motor vehicles, boats and other items specified by IRS. Sales taxes for items that may be added to the tables are not reflected in the tables.

The term “general sales tax” means a tax imposed at one rate on the retail sale of a broad range of classes of items. However, a lower rate or a tax exemption may be applied to some items of food, clothing, medical supplies, and motor vehicles. If a higher rate applies to motor vehicles, the excess is disregarded and the general rate is treated as the rate of tax.

A compensating use tax is treated as a general sales tax, provided it is complementary to a general sales tax and a deduction for sales taxes is allowable for similar items sold in the taxing jurisdiction.

**Example 2. Choice of Sales or Income Tax**

Winston Winn and his wife file a joint return and claim their two children as dependents. Their adjusted gross income (AGI) is $40,000, and their state taxable income is $30,000. Their state imposes a 7% general sales and use tax, and applies a unitary rate of 4% to taxable income for individuals. The Winns’ state income tax is $1,200. They did not keep all their receipts for 2004, and did not purchase a car. Assume the IRS table shows a $535 sales tax deduction for their state for a family of four with a $40,000 AGI. The Winns would choose to deduct their state and local income taxes rather than their allowance for sales taxes. Their tax is entered on line 5 of Schedule A (Form 1040) and box a is checked.
FIGURE 1 2004 Schedule A Change

<table>
<thead>
<tr>
<th>Taxes You Paid</th>
<th>5</th>
<th>State and local (check only one box):</th>
</tr>
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<tbody>
<tr>
<td></td>
<td></td>
<td>a Income taxes, or</td>
</tr>
<tr>
<td></td>
<td></td>
<td>b □ General sales taxes (see page A-2)</td>
</tr>
<tr>
<td>6</td>
<td></td>
<td>Real estate taxes (see page A-3),</td>
</tr>
<tr>
<td>7</td>
<td></td>
<td>Personal property taxes</td>
</tr>
<tr>
<td>8</td>
<td></td>
<td>Other taxes. List type and amount</td>
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<tr>
<td>9</td>
<td></td>
<td>Add lines 5 through 8</td>
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<td>5</td>
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<td>7</td>
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<tr>
<td>8</td>
<td></td>
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</tbody>
</table>

Planning Pointer—Difference from Prior Law. The sales tax deduction allowed prior to its repeal by the Tax Reform Act of 1986 was based on a taxpayer’s total available income. The new law requires that the table amount be based on adjusted gross income. Taxpayers with significant tax-exempt income (including veterans’ benefits and social security benefits) who itemize their deductions should be advised to retain their receipts, since their actual sales tax expense may be larger than the table amount.

Income Averaging for Farmers and Fishers
I.R.C. §1301, Act §314
Effective for tax years beginning after 2003

Background
An individual taxpayer engaged in a farming business (as defined by I.R.C. §263A(e)(4)) may elect to compute his or her current year regular tax liability by averaging, over the prior three-year period, all or a portion of his or her taxable income from the trade or business of farming. Because farmer income averaging reduces the regular tax liability, the AMT may be increased. Thus, the benefits of farmer income averaging may be reduced or eliminated for farmers subject to the AMT.

New Law
The Jobs Act of 2004 provides that, in computing AMT, a farmer’s regular tax liability is determined without regard to farmer income averaging. Thus, a farmer receives the full benefit of income averaging because averaging reduces the regular tax while the AMT (if any) remains unchanged.

Example 3. Effect of Income Averaging on AMT
Clay and Lilly Fields had $120,000 of net income from farming in 2004 and no other income. They had $50,000 of AMT adjustments. Without income averaging, their 2004 regular tax liability would be $17,736. Their tentative minimum tax is $24,763, which results in a $7,027 ($24,763 – $17,736) AMT liability.

If the Fields elect to use income averaging, they can reduce their regular tax liability by $5,195. Before the change to I.R.C. §1301 by the Jobs Act of 2004, their AMT would have gone up by the same amount so their total tax liability for 2004 would not have changed. After the Jobs Act of 2004 change, their AMT liability remains the same and the Field’s total tax for 2004 is reduced by the $5,195 reduction of regular taxes.

The Jobs Act of 2004 also extends the benefits of income averaging to fishermen.

Rural Letter Carrier Expenses
I.R.C. §162(o); Act §318

Background
The deductible automobile expenses of rural letter carriers are deemed to equal the reimbursements that they receive from the U.S. Postal Service. Carriers are not allowed to document their actual costs and claim itemized deductions for costs in excess of reimbursements, nor are carriers required to include in income reimbursements in excess of their actual costs.
New Law
Under the Jobs Act of 2004, if the reimbursements a rural letter carrier receives from the U.S. Postal Service fall short of the carrier’s actual costs, the costs in excess of reimbursements qualify as a miscellaneous itemized deduction subject to the 2% of AGI floor. Reimbursements in excess of their actual costs continue not to be required to be included in gross income.

Health Service Corps Loans
I.R.C. §108, Act §320
Effective with respect to amounts received in taxable years beginning after December 31, 2003.

Background
The National Health Service Corps Loan Repayment Program (the “NHSC Loan Repayment Program”) provides education loan repayments to participants on condition that the participants provide certain services such as medical services in a geographic area identified by the Public Health Service as having a shortage of healthcare professionals. States may also provide for education loan repayment programs for persons who agree to provide primary health services in health professional shortage areas.

Because the loan repayments provided under the NHSC Loan Repayment Program or similar State programs under the Public Health Service Act are not specifically excluded from gross income, they are gross income to the recipient. There is also no exception from employment taxes (FICA and FUTA) for such loan repayments.

New Law
The Jobs Act of 2004 excludes from gross income and employment taxes education loan repayments provided under the NHSC Loan Repayment Program and State programs eligible for funds under the Public Health Service Act. The provision also provides that such repayments are not taken into account as wages in determining benefits under the Social Security Act.

Interest Paid by Foreign Partnerships
I.R.C. §861(a); Act §410
Effective for tax years beginning after December 31, 2003

Background
Interest income from obligations of U.S. residents or domestic corporations is treated as U.S.-source income. Interest on obligations of foreign corporations and foreign partnerships generally is treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is treated as a U.S. resident for this purpose if at any time during its taxable year it is engaged in a trade or business in the United States. Therefore, any interest received from the foreign partnership is U.S.-source income.

New Law
The Jobs Act of 2004 provides that interest paid by foreign partnerships predominantly engaged in the active conduct of a trade or business outside the United States will be treated like interest paid by foreign corporations: It is treated as U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income effectively connected with the conduct of a U.S. trade or business.

Suspension of Interest on Unpaid Taxes
I.R.C. §6404; Act §903
Effective for taxable years beginning after December 31, 2003, except that the addition of listed and reportable avoidance transactions applies to interest accruing after October 3, 2004.

Background
In general, interest and penalties accrue during periods for which taxes were unpaid without regard to whether the taxpayer was aware that there was tax due. The Code suspends the accrual of certain penalties and interest after 1 year after the filing of the tax return if the IRS has not sent the taxpayer a notice specifically stating the taxpayer’s liability and the basis for
the liability within the specified period. With respect to taxable years beginning before January 1, 2004, the 1-year period is increased to 18 months. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax. The suspension only applies to taxpayers who file a timely tax return. The provision applies only to individuals and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties.

New Law
The Jobs Act of 2004 makes the 18-month rule the permanent rule. It also adds gross misstatements and listed and reportable avoidance transactions to the list of provisions to which the suspension of interest rules do not apply.

Legal Fees for Discrimination Settlements
I.R.C. §62; Act §703
Effective for fees and costs paid after October 22, 2004

Background
Damages (other than damages received on account of personal physical injuries, including death) or physical sickness are generally included in gross income. The related expenses to recover the damages, including attorneys’ fees, are generally deductible as expenses for the production of income, subject to the 2% of AGI floor on itemized deductions. Any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the taxpayer’s AGI exceeds a threshold amount. For purposes of the alternative minimum tax, no deduction is allowed for any miscellaneous itemized deduction.

In some cases, claimants engage an attorney to represent them on a contingent fee basis. That is, if the claimant recovers damages, a prearranged percentage of the damages will be paid to the attorney; if no damages are recovered, the attorney is not paid a fee. The proper tax treatment of contingent fee arrangements with attorneys has been litigated in recent years.

Some courts have held that the entire amount of damages is income and that the claimant is entitled to a miscellaneous itemized deduction subject to both the 2% of AGI floor as an expense for the production of income for the portion paid to the attorney and to the overall limitation on itemized deductions. Other courts have held that the portion of the recovery that is paid directly to the attorney is not income to the claimant, holding that the claimant has no claim of right to that portion of the recovery.

New Law
The Jobs Act of 2004 provides an above-the-line deduction for attorneys’ fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving:

- A claim of unlawful discrimination,
- Certain claims against the federal government, or
- A private cause of action under the Medicare secondary payer statute.

The amount that may be deducted above the line may not exceed the amount includible in the taxpayer’s gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from the claim.

Exclusion of §1031 Property from §121 Treatment
I.R.C. §121(d); Act §840
Effective for sales or exchanges after October 22, 2004

Background
A taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. Tax-deferred like-kind exchanges are limited to property held for use in a trade or business or for investment. I.R.C. §1031 does not apply to the exchange of a personal residence. But there are no special rules relating to the sale
or exchange of a principal residence that was acquired in a like-kind exchange.

**New Law**
The Jobs Act of 2004 provides that the exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior 5 years, effective for sales or exchanges of principal residences after enactment.

**Example 4. Sale within 5 Years**
Max Imiz wanted to dispose of his rental property and acquire a new personal residence. On March 31, 2002, he utilized the I.R.C. §1031 provisions to exchange three rental houses (aggregate adjusted basis $60,000 and aggregate FMV $240,000) for a $500,000 single-family home with a $260,000 mortgage. He leased the replacement house to an unrelated person for 12 months. In May 2003, Max moved his family into the replacement house. In May 2005, Max lost his job and can no longer afford the payments on his mortgage. If he sells the house before April 1, 2007, he will be ineligible to exclude any of the gain under I.R.C. §121, even though he has met the 2-year ownership and use tests.

**Practitioner Note—Period between Exchange and Conversion.** The new law does not provide guidance or a required time frame for a frequently asked question: How long must a house acquired in a like-kind exchange be maintained as income-producing property before it can be converted to a personal residence?

**Stock Option Income Excluded from Social Security Wages**
I.R.C. §§421(b), 3121, 3231, 3306; Act §251
Effective for options exercised after October 22, 2004

**Background**
When there is a disqualifying disposition (the statutory holding period is not satisfied) of stock acquired pursuant to the exercise of a statutory stock option, compensation income is recognized on the disposition. There is no statutory exception from employment taxes for the deemed wages paid to an employee arising from a disqualified disposition, and there has been uncertainty as to employer withholding obligations. In 2002, the IRS announced that until further guidance is issued, it would not impose employment tax obligations on either the exercise of a statutory stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.

**New Law**
The Jobs Act of 2004 provides that transfers or dispositions of stock acquired through an incentive stock option plan or an employee stock purchase plan (ESPP) are exempt from social security, medicare, railroad retirement, and federal unemployment taxes. Income tax withholding is not required either for disqualifying dispositions or when compensation is recognized because of an ESPP discount.

**Statutory Stock Options Sold to Comply With Federal Conflict of Interest Requirements**
I.R.C. §421; Act §905
Effective for sales after October 22, 2004

**Background**
Statutory Stock Options
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. Upon such exercise, an employer is allowed a corresponding compensation deduction. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as “statutory stock options”), the spread is not included in income at the time of exercise.
If an employee disposes of stock acquired upon the exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement. The employee fails to meet this holding period requirement if the disposition occurs within 2 years after the date the option is granted or 1 year after the date the option is exercised. The gain upon a disposition that occurs prior to the expiration of the applicable holding period(s) (a “disqualifying disposition”) does not qualify for capital gains treatment. In the event of a disqualifying disposition, the income attributable to the disposition is treated by the employee as income received in the taxable year in which the disposition occurs, and a corresponding deduction is allowable to the employer for the taxable year in which the disposition occurs.

Sale of Property to Comply with Conflict of Interest Requirements

The Code provides special rules for recognizing gain on sales of property that are required in order to comply with certain conflict of interest requirements imposed by the federal government. Certain executive branch federal employees (and their spouses and minor or dependent children) who are required to divest property in order to comply with conflict of interest requirements may elect to postpone the recognition of resulting gains by investing in certain replacement property within a 60-day period. The basis of the replacement property is reduced by the amount of the gain not recognized. Permitted replacement property is limited to any obligation of the United States or any diversified investment fund approved by regulations issued by the Office of Government Ethics. The rule applies only to sales under certificates of divestiture issued by the President or the Director of the Office of Government Ethics.

New Law

Under the Job Act of 2004, an eligible person who, in order to comply with federal conflict of interest requirements, is required to sell shares of stock acquired pursuant to the exercise of a statutory stock option is treated as satisfying the statutory holding period requirements, regardless of how long the stock was actually held. An eligible person generally includes an officer or employee of the executive branch of the federal government (and any spouse or minor or dependent children whose ownership in property is attributable to the officer or employee). Because the sale is not treated as a disqualifying disposition, the individual is afforded capital gain treatment on any resulting gains. Such gains are eligible for deferral treatment under I.R.C. §1043.

The employer granting the option is not allowed a deduction upon the sale of the stock by the individual.

Personal Use of Aircraft and Entertainment Expenses

I.R.C. §274; Act §907
Effective for expenses incurred after October 22, 2004

Background

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. In general, an employee or other service provider must include in gross income the amount by which the fair value of a fringe benefit exceeds the amount paid by the individual. Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft. In general, the value of a non-commercial flight is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level (SIFL) formula. If the SIFL formula does not apply, the value of a flight on a company-provided aircraft is generally equal to the amount that an individual would have to pay in an arm’s-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.

In the context of an employer providing an aircraft to employees for nonbusiness (e.g., vacation) flights, under prior law, the company’s deduction for operation of the aircraft was not limited to the amount of compensation reportable to its employees, which could result in a
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deduction multiple times larger than the amount required to be included in income. In many cases, the individual including amounts attributable to personal travel in income directly benefited from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

New Law

Under the Jobs Act of 2004, in the case of covered employees, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income. Covered employees generally include officers (as defined by I.R.C. §162(m)(3)), directors, and 10%-or-greater owners of private and publicly held companies. No deduction is allowed with respect to expenses for

1. A nonbusiness activity generally considered to be entertainment, amusement or recreation, or
2. A facility (e.g., an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income to the covered employee.

For example, a company’s deduction attributable to aircraft operating costs for a covered employee’s vacation use of a company aircraft is limited to the amount reported as compensation to the employee. As under prior law, the amount of the deduction cannot exceed the actual cost.

The provision is intended to overturn Sutherland Lumber-Southwest, Inc. v. Commissioner with respect to covered employees. As under prior law, the exceptions apply only if amounts are properly reported by the company as compensation and wages or otherwise includible in income.

Charitable Contributions of Intellectual Property

I.R.C. §§170 and 6050L; Act §882
Effective for contributions after June 3, 2004

New Law

Under the Jobs Act of 2004, if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the taxpayer’s initial charitable deduction is limited to the lesser of the taxpayer’s basis in the contributed property or the fair market value of the property. In addition, the taxpayer is permitted to deduct, as a charitable deduction, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed property. For this purpose, “qualified donee income” includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).

Noncash Charitable Contributions

I.R.C. §170; Act §883
Effective for contributions made after June 3, 2004

New Law

The Jobs Act of 2004 has two provisions that affect donor reporting for certain charitable contributions of property other than cash, inventory, or publicly traded securities.

C Corporations

One provision extends to all C corporations the requirement that the donor must obtain a qualified appraisal of the property if the amount of the deduction claimed exceeds $5,000. This requirement applied only to an individual, closely-held corporation, personal service corporation, partnership, or S corporation under prior law.

Appraisal Required

The Jobs Act of 2004 also provides that if the amount of the contribution of property other than cash, inventory, or publicly traded securities exceeds $500,000, then the donor (whether an individual, partnership, or corporation) must attach the qualified appraisal to the donor’s tax return. For purposes of the dollar thresholds
under the provision, property and all similar items of property donated to one or more donees are treated as one property.

A donor that fails to substantiate a charitable contribution of property, as required by the Secretary, is denied a charitable contribution deduction. If the donor is a partnership or S corporation, the deduction is denied at the partner or shareholder level. The denial of the deduction does not apply if it is shown that such failure is due to reasonable cause and not to willful neglect.

Appraisals are not required for charitable contributions of certain vehicles that are sold by the donee organization without a significant intervening use or material improvement of the vehicle by the organization. The organization must provide an acknowledgement to the donor containing

- A certification that the vehicle was sold in an arm’s length transaction between unrelated parties,
- The gross sales proceeds from the sale, and
- A statement that the donor’s deductible amount may not exceed the amount of such gross proceeds.

**Racetrack Depreciation**

I.R.C. §168; Act §704
Effective for property placed in service after October 22, 2004 and before January 1, 2008

Under the Jobs Act of 2004 permanent motorsports racetrack complexes are 7-year recovery property. Motorsports racetrack complexes include land improvements and support facilities but do not include transportation equipment, warehouses, administrative buildings, hotels, or motels. Racetrack facilities placed in service after October 22, 2004 are excluded from the definition of theme and amusement facilities classified under Asset Class 80.0. The committee reports say no inference is intended with respect to the treatment of expenses incurred prior to the effective date.

**Recovery Period for Restaurant Property and Qualified Leasehold Improvements**

I.R.C. §168; Act §211
Effective for property placed in service after October 22, 2004 and before January 1, 2006

**Background**

The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

**New Law**

The Jobs Act of 2004 provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2006. For purposes of the provision, qualified restaurant property means any improvement to a building if such improvement is placed in service more than 3 years after the date such building was first placed in service and more than 50% of the building’s square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals.

The provision requires that qualified restaurant property be recovered using the straight-line method. The ADS period is 39 years.

**Limitation on SUV Expensing**

I.R.C. §179; Act §910
Effective for property placed in service after October 22, 2004

**New Law**

The Jobs Act of 2004 limits the I.R.C. §179 deduction to $25,000 for certain vehicles not subject to the passenger automobile limitations. (The passenger automobile limitation applies to vehicles with a gross vehicle weight of 6,000 pounds or less.) The provision applies to sport
utility vehicles rated at 14,000 pounds gross vehicle weight or less. For this purpose, a sport utility vehicle is defined to exclude any vehicle that:

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 driver’s seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Sale of Multiple Units under One Lease
I.R.C. §168; Act §337
Effective for property sold after June 4, 2004

New Law
For purposes of bonus depreciation, when multiple units of property are subject to the same lease, the property will qualify as placed in service by the user on the date of sale if it is sold to the user within 3 months after the final unit is placed in service, if the user does not change and the period of time between the first and last units being placed in service does not exceed 12 months. (This is an addition to the Working Families Tax Relief Act provision that when property is originally placed in service by a lessor and sold within 3 months, and the user of the property does not change, then the property is treated as originally placed in service by the user not earlier than the date of sale.)

Income Forecast Method of Depreciation
I.R.C. §167; Act §241
Effective for property placed in service after October 22, 2004

New Law
A taxpayer using the income forecast method of depreciation may include participations and residuals in the property’s adjusted basis if the expenses relate to income to be derived before the close of the tenth taxable year following the year the property is placed in service.

- Participations and residuals are costs that, by contract, will vary with the amount of income earned. Income taken into account under the income forecast method is the gross income from the property. Distribution costs are not taken into account for purposes of determining forecasted income.
- Treasury may prescribe adjustments to basis and to the look-back method for related interest (which applies if the income forecast varies by more than 10% from the actual income in the recomputation years).
- Inclusion of participations and residuals in basis is an option: If property is eligible for the income forecast method, the taxpayer may deduct those payments as they are paid as under Associated Patentees, Inc. v. Commissioner, 4 T.C. 979 (1945). This may be done on a property-by-property basis and shall be applied consistently with respect to a given property thereafter.

Film and Television Production
I.R.C. §181; Act §244
Effective for property placed in service after October 22, 2004 and before January 1, 2009

New Law
The Jobs Act of 2004 permits qualifying film and television productions to elect to deduct certain production expenditures in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.

Reforestation Expenditures
I.R.C. §194; Act §322
Effective for expenditures incurred or paid after October 22, 2004

New Law
The reforestation credit (I.R.C. §48) is repealed and replaced with an expense deduction of up to $10,000 of qualified reforestation expenditures in the year paid or incurred. Qualified reforesta-
tion expenditures above $10,000 can be amortized over 84 months.

**Acquisitions of Sports Franchises**

I.R.C. §197; Act §886  
Effective for property and franchises acquired after October 22, 2004

**New Law**

The Jobs Act of 2004 extends the 15-year recovery period for intangible assets to franchises to engage in professional sports and any intangible asset acquired in connection with the acquisition of such a franchise (including player contracts). Thus, the same rules for amortization of intangibles that apply to other acquisitions will apply to acquisitions of sports franchises. The provision also repeals the special rules under I.R.C. §1245(a)(4) and makes other conforming changes.

**Amortization Period for Intangibles**

I.R.C. §§195, 248 and 709; Act §902  
Effective for expenditures after October 22, 2004

**Background**

Under prior law, taxpayers could elect to amortize start-up expenditures and organizational expenditures over a period of not less than 60 months, beginning with the month in which the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses, had they not been paid or incurred before business began. Organizational expenditures are expenditures that are incident to the creation of a corporation (I.R.C. §248) or the organization of a partnership (I.R.C. §709), are chargeable to capital, and that would be eligible for amortization had they been paid or incurred in connection with the organization of a corporation or partnership with a limited or ascertainable life.

I.R.C. §197 requires most acquired intangible assets (such as goodwill, trademarks, franchises, and patents) that are held in connection with the conduct of a trade or business or an activity for the production of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

**New Law**

The Jobs Act of 2004 modifies the treatment of start-up and organizational expenditures. A taxpayer is allowed to elect to deduct up to $5,000 of start-up and $5,000 of organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Startup and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for I.R.C. §197 intangibles. Start-up and organizational expenditures that are incurred on or before October 22, 2004 continue to be eligible to be amortized over a period not to exceed 60 months. However, all start-up and organizational expenditures related to a particular trade or business, whether incurred before or after the date of enactment, are considered in determining whether the cumulative cost of start-up or organizational expenditures exceeds $50,000.

**Leasing Arrangements with Tax-Exempt Entities**

I.R.C. §§167, 168, 197 and 470; Act §§847, 848 and 849  
Effective for leases entered into after March 12, 2004, except for intangibles and Indian tribal governments for which the effective date is October 3, 2004

**New Law**

The Jobs Act of 2004 modifies the recovery period of certain property leased to a tax-exempt entity, alters the definition of lease term for all property leased to a tax-exempt entity, expands the short-term lease exception for qualified technological equipment, and establishes rules to limit deductions associated with leases to tax-exempt entities if the leases do not satisfy specified criteria.

The Jobs Act of 2004 expands the definition of tax-exempt entity for this purpose to include
certain Indian tribal governments in addition to federal, state, local, and foreign governmental units, charities, foreign entities or persons. It also modifies the recovery period for certain intangibles leased to a tax-exempt entity to be the no less than 125% of the lease term. The modification does not apply to certain short-term leases.

The Jobs Act of 2004 provides an additional requirement that must be satisfied to avoid the deduction limitations for certain leases of property to tax-exempt parties. This requirement provides that the tax-exempt lessee may not have an option to purchase the leased property for any stated purchase price other than the FMV of the property (as determined at the time of exercise of the option). This requirement does not apply to

1. Property with a class life (as defined in I.R.C. §168(i)(1)) of 7 years or less, or
2. Any fixed wing aircraft or vessels (i.e., ships).

The treatment of any qualified motor vehicle operating agreement (within the meaning of I.R.C. §7701(h)) is not altered. The requirements relating to taxpayer equity investment and tax-exempt lessee risk are applied without regard to any terminal rental adjustment clause. I.R.C. §470 does not apply to leased property located in the U.S. for which a formal application was submitted for approval to the Federal Transit Administration after June 30, 2003, and before March 13, 2004, is approved by the FTA before January 1, 2006, and includes a description and the fair market value of such property.

**Partnership Loss Transfers and Basis Adjustments**

I.R.C. §§704, 734, 743; Act §833

Effective for contributions, transfers and distributions after October 22, 2004

**Background**

When a partner contributes property to a partnership, generally no gain or loss is recognized at the time of contribution. The partnership takes the property at an adjusted basis equal to the contributing partner’s adjusted basis in the property, and any items of partnership income, gain, loss and deduction with respect to the contributed property are allocated among the partners to take into account any built-in gain or loss at the time of the contribution. If the contributing partner transfers its partnership interest, the built-in gain or loss is allocated to the transferee partner. But if the contributing partner’s interest is liquidated, there is no specific guidance preventing the allocation of the built-in loss to the remaining partners. Thus, it appears that losses can be transferred to other partners where the contributing partner no longer remains a partner.

**Transfers of Partnership Interests**

A partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a one-time election under I.R.C. §754 to make basis adjustments. If a partner purchases an interest in a partnership with an existing built-in loss and no election under I.R.C. §754 is in effect, the transferee partner may be allocated a share of the loss when the partnership disposes of the property (or depreciates the property).

**Distributions of Partnership Property**

With certain exceptions, partners may receive distributions of partnership property without recognition of gain or loss by either the partner or the partnership. When a partner’s interest is liquidated, the basis of the property distributed in the liquidation is equal to the partner’s adjusted basis in its partnership interest (reduced by any money distributed in the transaction). In non-liquidating distributions, the partner’s basis in the distributed property equals the lesser of the partnership’s adjusted basis in the property or the partner’s adjusted basis in the partnership interest (reduced by any money distributed in the same transaction).

If a partnership interest is transferred to a partner and the partnership has not made an I.R.C. §754 election, a special basis rule applies for determining the transferee partner’s basis of properties that are later distributed by the partnership. If property is distributed by a partnership within 2 years following the transfer of the partnership interest, the transferee may elect to determine its basis as if the partnership had adjusted the basis of the distributed property under I.R.C. §743(b) on the transfer. The special basis rule also applies if, at the time of the transfer, the FMV of partnership property other than money exceeds 110% of the partnership’s basis.
in the property and a liquidation of the partnership interest immediately after the transfer would have resulted in a shift of basis to property subject to an allowance of depreciation, depletion or amortization.

A partnership with no election in effect under I.R.C. §754 may distribute property with an adjusted basis lower than the distributee partner’s proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

**New Law**

The Jobs Act of 2004 provides:

- If loss property is contributed to a partnership and the contributing partner’s partnership interest is transferred or liquidated, the partnership’s adjusted basis in the property is based on its FMV at the time of contribution and the built-in loss is eliminated. It cannot be allocated to the remaining partners.

- The basis adjustment rules under I.R.C. §743 are mandatory when there is a transfer of a partnership interest with a substantial built-in loss (rather than being elective as under present law). A substantial built-in loss exists if the partnership’s adjusted basis in its property exceeds its FMV by more than $250,000. There is an exception for corporations: A corporation succeeding to attributes of the contributing corporate partner under I.R.C. §381 is treated in the same manner as the contributing partner.

- A basis adjustment under I.R.C. §734(b) is required when there is a distribution of property with a substantial basis reduction. A substantial basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a §754 election were in effect.

- An *electing investment partnership* (very specific rules apply) is not treated as having a substantial built-in loss, and thus is not required to make basis adjustments to partnership property in the case of a transfer of a partnership interest. In lieu of the partnership basis adjustments, a partner-level loss limitation rule applies. Electing investment partnerships will generally include venture capital funds, buyout funds, and other such funds formed to raise capital from investors pursuant to a private offering and to make investments during the limited term of the partnership with the intention of holding the investments for capital appreciation.

- An exception also applies to *securitization partnerships*. Partnership basis adjustments will remain elective and the partner-level loss limitation rule does not apply. A securitization partnership has a sole business activity of issuing securities that provide for a fixed principal and that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets that by their terms convert into cash in a finite period.

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**Example 5. Basis Decrease on Transfer**

Arthur holds a 25% interest in the Camelot partnership. He sells his interest to Bea for its FMV of $1 million. Immediately after the transfer, the FMV of Camelot’s assets is $4 million and Camelot’s adjusted basis in the assets is $4.3 million. Camelot is required to adjust the basis of its assets with respect to Bea. As a result, Bea will recognize no gain or loss if Camelot immediately sold all of its assets for their FMV.

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**Example 6. No Required Basis Decrease on Transfer**

Arthur holds a 25% interest in the Camelot partnership. He sells his interest to Bea for its FMV of $100,000. Immediately after the transfer, the FMV of Camelot’s assets is $400,000 and Camelot’s adjusted basis in the assets is $430,000. Camelot is not required to adjust the basis of its assets with respect to Bea because the difference in basis and FMV is less than $250,000.

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**Example 7. Basis Adjustment on Distribution**

Alex and Bonnie each contributed $2.5 million to a newly formed partnership (StormySeas) and Charley contributed $5 million. StormySeas purchased LMN stock for $3 million and XYZ stock.
for $7 million. The value of each stock then declined to $1 million, and the LMN stock was distributed to Charley in liquidation of his partnership interest. The basis of LMN stock in Charley’s hands is $5 million (rather than its $3 million basis to the partnership), and he will recognize a loss of $4 million if he sells the LMN stock for $1 million.

Because the $2 million increase in the adjusted basis of the LMN stock is greater than $250,000, StormySeas is required to decrease the basis of the undistributed XYZ stock. The $2 million decrease leaves a basis of $5 million. If the XYZ stock were then sold by the partnership for $1 million, Alex and Bonnie would each recognize a loss of $2 million.

No §734 Basis Reduction in Corporate Partner’s Stock
I.R.C. §755; Act §834
Effective for distributions after October 22, 2004

Background
When a partnership distributes partnership property, the basis of partnership property generally is not adjusted to reflect the effects of the distribution or transfer. However, the partnership is permitted to make an I.R.C. §754 election to adjust the basis of partnership property when there is a change in the distributed property’s basis in the hands of the distributee partner resulting from the distribution.

New Law
The Jobs Act of 2004 provides that, in applying the basis allocation rules to a distribution in liquidation of a partner’s interest, a partnership cannot decrease the basis of the corporate stock of a partner or a related person. Any decrease in basis that would have been allocated to the stock is allocated to other partnership assets. If the decrease exceeds the basis of the other partnership assets, gain is recognized by the partnership in the amount of the excess.

Example 8. Basis Adjustment on Distribution
Assume that XYZ Corp. is a partner in StormySeas (Example 7). StormySeas may not reduce the basis of the XYZ stock after the distribution to Charley. If the XYZ stock is the partnership’s only remaining asset, StormySeas must recognize a $2 million gain.

Partnership Debt Cancellation
I.R.C. §108; Act §896
Effective for cancellation of debt on or after October 22, 2004

New Law
When a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt, the partnership must recognize cancellation of indebtedness income in the amount that would be recognized if the debt were satisfied with money equal to the fair market value of the partnership interest, with no regard to whether the cancelled debt is recourse or nonrecourse indebtedness. The cancellation of indebtedness income is allocated solely among the partners who held interests in the partnership immediately prior to the satisfaction of the debt. No inference is intended as to the treatment under present law of the transfer of a partnership interest in satisfaction of partnership debt.

Limitation on Corporation Built-In Losses
I.R.C. §334, 362; Act §836
Effective for transactions after October 22, 2004

Background
Generally, no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation. The basis of property received by a corporation (whether from domestic or foreign transferors) in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation is the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.
New Law

The Jobs Act of 2004 provides that if a net built-in loss is imported into the U.S. in a tax-free organization or reorganization from persons not subject to U.S. tax, the basis of each property transferred is its FMV. A similar rule applies to the tax-free liquidation of a foreign subsidiary by a domestic corporation.

- If the aggregate adjusted bases of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceed the aggregate FMV of the property transferred in a tax-free (I.R.C. §351) incorporation, the transferee’s aggregate basis of the properties is limited to the aggregate FMV of the transferred property. Any required basis reduction is allocated among the transferred properties in proportion to their built-in loss immediately before the transaction.
- The transferee may irrevocably elect to have the stock received by the transferor限 to the aggregate FMV of the transferred property, in lieu of limiting the basis in the assets transferred.

Controlled Group of Corporations

I.R.C. §1563; Act §900
Effective for tax years beginning after October 22, 2004

New Law

The Jobs Act of 2004 changes the definition of a brother-sister controlled group for purposes of the I.R.C. §1561 rules that members of a controlled group must share the amounts in each of the corporate income tax brackets, the accumulated earnings credit, and the alternative minimum tax exemption. The component members of a controlled group of corporations are limited to one amount in each of the corporate taxable income brackets.

Under the new law, a brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates or trusts own (or constructively own) stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation. (Under the prior rule, a brother-sister controlled group meant two or more corporations if five or fewer persons who are individuals, estates or trusts own stock possessing (1) at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total value of all stock, and (2) more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation.)

Dividends Paid by Cooperatives

I.R.C. §1388; Act §312
Effective for tax years beginning after October 22, 2004

Practitioner Note—Committee Reports Differ. The committee reports say the effective date is for taxable years ending after October 22, 2004. If that is what Congress meant, a technical correction is needed to change the effective date.

Background

Cooperatives generally are entitled to deduct or exclude amounts distributed as patronage dividends. In general, patronage dividends are comprised of amounts that are paid to patrons:

1. On the basis of the quantity or value of business done with or for patrons,
2. Under a valid and enforceable obligation to pay such amounts that was in existence before the cooperative received the amounts paid, and
3. That are determined by reference to the net earnings of the cooperative from business done with or for patrons.

Under prior law, net earnings were reduced by dividends paid on capital stock or other proprietary capital interests (referred to as the “dividend allocation rule”). The dividend allocation rule has been interpreted to require that such
dividends be allocated between a cooperative's patronage and nonpatronage operations, with the amount allocated to the patronage operations reducing the net earnings available for the payment of patronage dividends.

**New Law**
The Jobs Act of 2004 provides a special rule for dividends on capital stock of a cooperative. To the extent provided in organizational documents of the cooperative, dividends on capital stock do not reduce patronage income and do not prevent the cooperative from being treated as operating on a cooperative basis.

**Apportionment of Small Ethanol Producer Credit by Cooperatives**
I.R.C. §40(g); Act §313
Effective for tax years ending after October 22, 2004

**New Law**
Cooperatives may elect to pass the I.R.C. §40 small ethanol producer credit through to their patrons on the basis of the quantity or value of business done with or for such patrons for the taxable year. The election must be made on a timely filed return for the taxable year, and once made, is irrevocable for that taxable year. The amount of the credit not apportioned to patrons is included in the organization’s credit for the taxable year of the organization.

**Value-added Processing of Animals by Cooperatives**
I.R.C. §1388; Act §316
Effective for tax years beginning after October 22, 2004

**New Law**
The Jobs Act of 2004 extends the declaratory judgment procedures to cooperatives. If IRS fails to act on an application for tax-exempt status under IRC §521, a farm cooperative may seek a declaratory judgment in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims. The court has jurisdiction to determine a cooperative’s initial or continuing qualification.

**IRA as Bank S Corporation Shareholder**
I.R.C. §§512, 1361, 4975; Act §233
Effective on October 22, 2004

**Background**
Although qualified retirement plans may be S corporation shareholders, an individual retirement account (IRA) cannot be a shareholder in an S corporation. In addition, sales of property between an IRA and the individual for whose benefit the IRA is established are prohibited transactions. If a prohibited transaction occurs...
between an IRA and the IRA beneficiary, the account ceases to be an IRA, and an amount equal to the FMV of the assets held in the IRA is deemed distributed to the beneficiary.

New Law
The Jobs Act of 2004 provides that an IRA trust (including a Roth IRA) is an eligible shareholder in a bank that makes an S corporation election if it already held the bank stock as of the date of enactment. The IRA owner is counted (not taxed) as the shareholder. In an exception to the prohibited transaction rules, the IRA trust may sell the stock to the IRA owner at its FMV (cash only) no later than 120 days after the bank makes an S election.

Practitioner Note—Other S Corporations Not Included. This limited exception applies only to banks. IRAs still cannot hold stock in other S corporations.

Renewable Resource Electricity Credit
I.R.C. §45; Act §710

Background
An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified “closed-loop” biomass, or qualified poultry waste facilities. The amount of the credit is 1.8 cents per kilowatt hour for 2004. The credit amount is indexed for inflation. The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2006, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2006, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2006. The credit is allowable for production during the 10-year period after a facility is originally placed in service.

New Law
Five new qualifying renewable resources for the production of electricity are defined: open-loop biomass (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, and municipal solid waste (either landfill gas facilities or trash combustion facilities). In addition, refined coal is a qualifying resource.

- Qualifying open-loop biomass facilities must be placed in service prior to 2006. Qualifying agricultural livestock waste nutrient facilities can be placed in service after October 22, 2004 and before 2006. The installed capacity of a qualified agricultural livestock waste nutrient facility must be not less than 150 kilowatts.
- Qualifying geothermal energy facilities and qualifying solar energy facilities can be placed in service after October 22, 2004 and before 2006. Neither can have claimed any credit under I.R.C. §48.
- A qualified small irrigation power facility can be placed in service after October 22, 2004 and before 2006. It must generate electric power through an irrigation system canal or ditch without any dam or impoundment of water, and must have an installed capacity of not less than 150 kilowatts and less than five megawatts.
- Landfill gas is methane gas derived from the biodegradation of municipal solid waste. Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. Qualifying landfill gas facilities and qualifying trash combustion facilities include facilities used to produce electricity placed in service after October 22, 2004 and before 2006.
- Refined coal is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. The fuel must be sold with the reasonable expectation that it will be used for the primary purpose of producing steam. A qualifying refined coal facility can be placed in service after October 22, 2004 and before 2009.
For open-loop biomass facilities (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, landfill gas facilities, and trash combustion facilities, the 10-year credit period under I.R.C. §45 is reduced to 5 years commencing on the date the facility is placed in service. For facilities placed in service prior to January 1, 2005, the credit period commences on January 1, 2005.

For closed-loop biomass facilities modified to co-fire with coal and/or other biomass, the credit period begins no earlier than October 22, 2004.

For open-loop biomass facilities (including agricultural livestock waste nutrients), small irrigation power, landfill gas facilities, and trash combustion facilities, the otherwise allowable credit amount is reduced by one half.

An alternative credit applies for the production of refined coal.

The changes do not apply to any poultry waste facility placed in service prior to 2005. Such facilities placed in service after 2004 may qualify for credit as animal livestock waste nutrient facilities.

**New Markets Tax Credit**

I.R.C. §45D; Act §221
Effective after October 22, 2004

**Background**

The new markets tax credit applies to qualified equity investments in a qualified community development entity (CDE) that provide investment capital for low-income communities.

**New Law**

Businesses serving targeted populations will be eligible to receive capital contributions or loans from CDEs. Targeted populations that may be treated as communities are individuals (or an identifiable group of individuals, including an Indian tribe) who are low-income persons or who otherwise lack adequate access to loans or equity investments. Low-income means less than 80% of the applicable area’s median family income. A census tract with a population of less than 2,000 may qualify if it is within an empowerment zone and is contiguous to one or more low-income communities.

**Reporting of Mergers and Acquisitions**

I.R.C. §6043A; Act §805
Effective for acquisitions after October 22, 2004

**Background**

Brokers (including stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers. This requirement generally does not apply to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of I.R.C. §367).

**New Law**

The Jobs Act of 2004 requires information reporting when gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation’s acquisition of the stock or assets of the first corporation. The information return must describe the transaction, provide the name and address of each shareholder of the acquired corporation, the amount of money and the value of stock or other consideration paid to each shareholder and any other information the Treasury may prescribe.

**Estimated Tax for Certain Deemed Asset Sales**

I.R.C. §338(h); Act §839
Effective for transactions after October 22, 2004

**Background**

For purposes of I.R.C. §6655 (relating to additions to tax for failure by a corporation to pay estimated income tax), tax attributable to a deemed asset sale under I.R.C. §338(a)(1) is not taken into account. A deemed asset sale occurs when an election is made to treat a qualifying purchase of 80% of the stock of a target corporation as an acquisition of the assets of the target, rather than as a stock purchase.
New Law
The estimated tax payment exception does not apply to a qualified stock purchase for which an election is made under I.R.C. §338(h)(10). Estimated tax is determined based on the stock sale unless and until there is an agreement to make an I.R.C. §338(h)(10) election. If there is an agreement at the time of the sale, then estimated tax is computed based on an asset sale, computed from the date of the sale. If the agreement is concluded after the stock sale, so that the original computation was based on a stock sale, estimated tax is recomputed based on the asset sale election.

Deposits to Suspend Interest on Potential Underpayments
I.R.C §6603; Act §842
Effective for deposits made after October 22, 2004

Background
Interest on underpayments and overpayments generally accrues during the period that a taxpayer and the IRS dispute a liability. The accrual of interest on an underpayment is suspended if the IRS fails to notify an individual taxpayer in a timely manner, but interest will begin to accrue once the taxpayer is properly notified. The taxpayer may make a deposit in the nature of a cash bond, as provided in Rev. Proc. 84-58, 1984-2 CB 501. A deposit in the nature of a cash bond will stop the running of interest on an amount of underpayment equal to the deposit, but the deposit does not itself earn interest.

New Law
The Jobs Act of 2004 provides that a taxpayer may deposit cash with the IRS that may subsequently be used to pay an underpayment of taxes.

Deposited amounts that have not been used to pay a tax may be withdrawn if the taxpayer requests it in writing. Withdrawn amounts that are attributable to a disputable tax will earn interest at the short-term applicable federal rate for the period from the date of deposit to a date not more than 30 days preceding the date of the check paying the withdrawal.

Interest is not payable to the extent the deposit was not attributable to a disputable tax. All items included in a 30-day letter to a taxpayer are deemed disputable for this purpose.

A deposit is not a payment of tax prior to the time the deposited amount is used to pay a tax. Withdrawal of a deposit will not establish a period for which interest was allowable at the short-term applicable Federal rate for the purpose of establishing a net zero interest rate on a similar amount of underpayment for the same period.

A taxpayer may identify a deposit made under Rev. Proc. 84-58 as made under I.R.C. §6603, effective as of the identification date.

Example 9. Deposit to Stop Interest
Phil Larrup, a calendar year individual taxpayer, deposits $20,000 on May 15, 2005, with respect to a disputable item on his 2004 income tax return. On April 15, 2007, an examination of Phil’s 2004 income tax return is completed, and Phil and the IRS agree that the taxes were underpaid by $25,000. The $20,000 on deposit is used to pay $20,000 of the underpayment, and Phil also pays the remaining $5,000. Phil will owe interest from April 15, 2005 (the original due date of the return) to the date of payment (April 15, 2007) only for the $5,000 that is not paid by the deposit. He will owe interest on the remaining $20,000 of the underpayment only from April 15, 2005, to May 15, 2005, the date the $20,000 was deposited.

Example 10. Refund of Excess Deposit
Redd Robbins, a calendar year individual taxpayer, receives a 30-day letter showing a deficiency of $20,000 for taxable year 2004 and deposits $20,000 on May 15, 2006. On April 15,
2007, an administrative appeal is completed, and Redd and the IRS agree that the 2004 taxes were underpaid by $15,000. The deposit is used to pay the underpayment. Redd will owe interest from April 15, 2005 (the original due date of the return) to May 15, 2006, the date the $20,000 was deposited. Redd requests the return of the remaining amount of the deposit (after reduction for the underpayment interest owed). This amount ($5,000 minus the interest) is returned to Redd with interest determined at the short-term applicable federal rate paid from May 15, 2006, to a date not more than 30 days preceding the date of the check repaying the unused deposit.

Transfer of Excess Pension Assets
I.R.C. §420; Act §709
Effective for tax years ending after October 22, 2004

New Law
A pension plan that provides medical benefits to retired employees can transfer excess assets to a separate account used to fund the retiree health benefits. A qualified transfer must meet a minimum cost requirement, maintaining retiree health benefits at the same level for the year of the transfer and the following four years. If in the preceding taxable year, the qualified current retiree health liabilities of the employer were at least 5% of gross receipts, the employer will not fail the minimum cost requirement if there is an insignificant reduction in cost.

Stripped Interests in Funds
I.R.C. §§305, 1286; Act §831
Effective for purchases and dispositions after October 22, 2004

Background
An income-stripping transaction separates property from the right to receive future income generated by the property. Such transactions potentially may generate artificial losses on disposition of the property or defer recognition of taxable income associated with such property. The assignment of income doctrine generally applies when the right to receive income is transferred without an accompanying transfer of the underlying property, so that the transfer is not respected. Specific statutory rules address specific types of stripping transactions, such as transactions involving stripped bonds. I.R.C. §1286 treats the stripped bond and the detached interest coupons as individual bonds that are newly issued with original issue discount (OID). Similar rules apply under I.R.C. §305(e) for stripped preferred stocks and the stripped dividends. However, there are no specific statutory rules that address stripping transactions with respect to common stock or other equity interests.

New Law
The Jobs Act of 2004 authorizes the Treasury Department to promulgate regulations that apply rules similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an entity or account when substantially all of the assets consist of bonds, preferred stock, or any combination thereof.

Practitioner Note—Stripped Mutual Fund. The Treasury regulations could apply to a transaction in which a person effectively strips future dividends from shares in a money market mutual fund (and disposes of either the stripped shares or stripped future dividends) by contributing the shares (with the future dividends) to a custodial account through which another person purchases rights to either the stripped shares or the stripped future dividends.

Modification of Straddle Rules
I.R.C. §1092; Act §888
Effective for positions established on or after enactment

Background
When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle. Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.
The straddle rules generally do not apply to positions in stock. However, the straddle rules apply where one of the positions is stock and at least one of the offsetting positions is:

1. An option with respect to the stock,
2. A securities futures contract (as defined in I.R.C. §1234B) with respect to the stock, or
3. A position with respect to substantially similar or related property (other than stock) as defined in treasury regulations.

In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

**New Law**

The straddle rules are modified in three respects:

- Taxpayers generally are permitted to identify the offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle. If there is a loss with respect to any identified position that is part of an identified straddle, the general straddle loss deferral rules do not apply. Instead, the basis of each of the identified positions that offset the loss position in the identified straddle is increased by an amount that bears the same ratio to the loss as the unrecognized gain (if any) with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all positions that offset the loss position in the identified straddle.

- Prior-law straddle rules are clarified with respect to taxpayers that settle a position that is part of a straddle by delivering property to which the position relates. There is a two-step transaction: (1) The taxpayer is treated as having terminated the position for its fair market value immediately before the settlement, and (2) the taxpayer is treated as having sold at FMV the property used to physically settle the position.

- The exception from the straddle rules for stock (other than the exception relating to qualified covered call options) is repealed. Offsetting positions comprised of actively traded stock and a position with respect to substantially similar or related property generally constitute a straddle.

The required 46- or 91-day holding period for the dividends-received-deduction is modified by providing that it does not include any time the shareholder is protected from the risk of loss by writing an in-the-money call option on the dividend-paying stock.

**Deduction for Interest on Convertible Debt**

I.R.C. §163; Act §845

Effective for debt instruments issued after October 3, 2004

**Background**

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. The issuer of an equity investment generally cannot deduct dividends paid, although corporate holders generally may obtain a dividends-received deduction. The issuer of a debt instrument may deduct interest, subject to certain limitations. No deduction is allowed for interest on a debt instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in equity of the issuer or a related party.

**New Law**

The Jobs Act of 2004 expands the disallowance of interest deductions on convertible or equity-linked corporate debt to include interest on corporate debt payable in (or by reference to the value of) any equity held by the issuer or any related party in any other person, without regard to whether the equity represents more than a 50% ownership interest. This does not apply to debt issued by an active dealer in securities if the debt is payable in (or by reference to the value of) equity held by the securities dealer in its capacity as a dealer in securities.

**No Installment Sale Treatment for Readily Tradable Debt**

I.R.C. §453; Act §897

Effective for sales occurring on or after October 22, 2004
**Background**

The installment method of reporting gain on a sale is not available if the taxpayer sells property in exchange for a readily tradable evidence of indebtedness that is issued by a corporation or a government or political subdivision. No similar provision under prior law prohibits the use of the installment method where the taxpayer sells property in exchange for readily tradable indebtedness issued by a partnership or an individual.

**New Law**

The Jobs Act of 2004 denies installment sale treatment with respect to all sales in which the taxpayer receives indebtedness that is readily tradable, regardless of the nature of the issuer. For example, if the taxpayer receives readily tradable debt of a partnership in a sale, the partnership debt is treated as payment on the installment note, and the installment method is unavailable to the taxpayer.

**Transfers to Creditors in Divisive Reorganizations (Act §898)**

I.R.C. §§357 and 361; Act §898
Effective for transactions on or after October 22, 2004

**Background**

I.R.C. §355 permits a corporation (“distributing”) to separate its businesses by distributing a controlled subsidiary (“controlled”) tax-free, if certain conditions are met. In cases where the distributing corporation contributes property to the controlled corporation that is to be distributed, no gain or loss is recognized if the property is contributed solely in exchange for stock or securities of the controlled corporation (which are subsequently distributed to distributing corporation’s shareholders). The contribution of property to a controlled corporation that is followed by a distribution of its stock and securities may qualify as a reorganization described in I.R.C. §368(a)(1)(D). That section also applies to certain transactions that do not involve a distribution under I.R.C. §355 and that are considered “acquisitive” rather than “divisive” reorganizations.

The contribution in the course of a divisive I.R.C. §368(a)(1)(D) reorganization is also subject to the rules of I.R.C. §357(c). That section provides that the transferor corporation will recognize gain if the amount of liabilities assumed by controlled exceeds the basis of the property transferred to it.

Because the contribution transaction in connection with a I.R.C. §355 distribution is a reorganization under I.R.C. §368(a)(1)(D), it is also subject to certain rules applicable to both divisive and acquisitive reorganizations. One such rule, in I.R.C. §361(b), states that a transferor corporation will not recognize gain if it receives money or other property and distributes that money or other property to its shareholders or creditors. The amount of property that may be distributed to creditors without gain recognition is unlimited under this provision.

**New Law**

The Jobs Act of 2004 limits the amount of money plus the fair market value of other property that a distributing corporation can distribute to its creditors without gain recognition under I.R.C. §361(b) to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization. In addition, the new law provides that acquisitive reorganizations under I.R.C. §368(a)(1)(D) are no longer subject to the liabilities assumption rules of I.R.C. §357(c).

**Regulated Investment Companies**

I.R.C. §851(h); Act §331
Effective for tax years beginning after October 22, 2004

**Background**

In order to qualify for conduit treatment, a regulated investment company (RIC) must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act. In addition, the corporation must elect RIC status, and must satisfy certain other requirements.

One of the RIC qualification requirements is that at least 90% of the RIC’s gross income is derived from dividends, interest, payments with respect to securities loans, and gains from the
sale or other disposition of stock or securities or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies. Income derived from a partnership is treated as meeting this requirement only to the extent such income is attributable to items of income of the partnership that would meet the requirement if realized by the RIC in the same manner as realized by the partnership (the “look-through” rule for partnership income). Under prior law, no distinction was made under this rule between a publicly traded partnership and any other partnership.

New Law
The Jobs Act of 2004 modifies the 90% test with respect to income of a RIC to include net income derived from an interest in a publicly traded partnership. The new law also modifies the look-through rule for partnership income of a RIC so that it applies only to income from a partnership other than a publicly traded partnership.

The limitation on ownership and the limitation on composition of assets that apply to other investments of a RIC also apply to RIC investments in publicly traded partnership interests.

The special rule for publicly traded partnerships under the passive loss rules (requiring separate treatment) applies to a RIC holding an interest in a publicly traded partnership, with respect to items attributable to the interest in the publicly traded partnership.

Safe Harbor for Timber REIT
I.R.C. §857(b); Act §321
Effective for tax years beginning after October 22, 2004

Background
Real estate investment trusts (“REITs”) are subject to a special taxation regime. Under this regime, a REIT is allowed a deduction for dividends paid to its shareholders. As a result, REITs generally do not pay tax on distributed income. REITs are generally restricted to earning certain types of passive income, primarily rents from real property and interests on mortgages secured by real property.

To qualify as a REIT, a corporation must satisfy a number of requirements, among which are four tests: organizational structure, source of income, nature of assets, and distribution of income.

A 100% tax is imposed on the net income of a REIT from “prohibited transactions”. A prohibited transaction is the sale or other disposition of property held for sale in the ordinary course of a trade or business, other than foreclosure property.

Some REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT. The IRS has issued private letter rulings in particular instances stating that the income from the sale of the trees can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.

New Law
For tax years beginning after October 22, 2004, a safe harbor for a real estate investment trust that holds timberland will permit it to sell real estate assets and avoid the prohibited transaction rules.

Effectively Connected Income
I.R.C. §864(c)(4)(B); Act §894
Effective for tax years beginning after October 22, 2004

Background
Nonresident alien individuals and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons. Detailed rules apply for purposes of determining whether income is treated as effectively connected with a U.S. trade or business (so-called “U.S.-effectively connected income”). The rules differ depending on whether the income at issue is U.S-source or foreign-source income.

In general, foreign-source income is not treated as U.S.-effectively connected income.
However, foreign-source income, gain, deduction, or loss generally is considered to be effectively connected with a U.S. business only if the person has an office or other fixed place of business within the United States to which such income, gain, deduction, or loss is attributable and such income falls into one of three categories:

1. Rents or royalties for the use of patents, copyrights, secret processes, or formulas, good will, trademarks, trade brands, franchises, or other similar intangible properties derived in the active conduct of the U.S. trade or business.

2. Interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States, or received by a corporation whose principal business is trading in stocks or securities for its own account.

3. Income, gain, deduction, or loss derived from the sale or exchange of inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business where the property is sold or exchanged outside the United States through the foreign person’s U.S. office or other fixed place of business.

For these purposes, income generally is not considered attributable to an office or other fixed place of business within the United States unless such office or fixed place of business is a material factor in the production of the income, and such office or fixed place of business regularly carries on activities of the type that generate such income.

New Law
Each category of foreign-source income that is treated as effectively connected with a U.S. trade or business is expanded to include economic equivalents of such income (i.e., economic equivalents of certain foreign-source (1) rents and royalties, (2) dividends and interest, and (3) income on sales or exchanges of goods in the ordinary course of business). Thus, such economic equivalents are treated as U.S.-effectively connected income in the same circumstances that foreign-source rents, royalties, dividends, interest, or certain inventory sales are treated as U.S.-effectively connected income.

For example, foreign-source interest and dividend equivalents are treated as U.S.-effectively connected income if the income is attributable to a U.S. office of the foreign person, and such income is derived by such foreign person in the active conduct of a banking, financing, or similar business within the United States, or the foreign person is a corporation whose principal business is trading in stocks or securities for its own account.

Minimum Holding Period for Foreign Tax Credit
I.R.C. §901; Act §832
Effective for amounts paid or accrued after November 23, 2004

Background
A U.S. shareholder is denied the foreign tax credits normally available with respect to a dividend if the shareholder has not held the stock for a required holding period. No such rule applies to other types of foreign income.

New Law
The Jobs Act of 2004 provides that foreign tax credits may not be claimed for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer has not held the property for more than 15 days within a 31-day testing period (exclusive of periods during which the taxpayer is protected from risk of loss). The provision does not apply to certain income or gain that is received by active dealers. The secretary is to prescribe hedging regulations to provide that credits are not disallowed merely because a taxpayer eliminates its risk of loss from interest rate or currency fluctuations.

Foreign Tax Credit Carryover Period
I.R.C. §904; Act §417
Carryback effective for excess foreign taxes arising in tax years beginning after October 22, 2004

Effective Date During 2004
Carryforward effective for amounts carried to taxable years ending after October 22, 2004

**Background**
U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years (to the earliest year first) and carried forward five taxable years (in chronological order) to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years.

**New Law**
The Jobs Act of 2004 shortens the carryback period for creditable foreign taxes paid or accrued (or deemed paid) in any taxable year that exceed the foreign tax credit limitation to only one year, but the carry forward period is extended to 10 years. This includes amounts carried forward to 2004.

**Example 11. Extended Carryover Period**
Otto Worker receives dividend statements showing payment of a 15% foreign tax. His effective U.S. tax rate is only 12%, so Otto has been carrying forward excess foreign tax credits. His unused credit for 1999 was scheduled to expire if he could not use it to offset his 2004 tax. Now he can carry it forward for up to another five years.

**Partnership Attribution for Foreign Tax Credit**
I.R.C. §902; Act §405
Effective for foreign tax years beginning after October 22, 2004

**Background**
A domestic corporation that receives a dividend from a foreign corporation in which it owns 10% or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by the foreign corporation. Thus, the domestic corporation is eligible to claim a foreign tax credit with respect to the deemed-paid taxes. The foreign tax credit provisions do not specifically address whether a domestic corporation owning 10% or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.

**New Law**
The Jobs Act of 2004 provides that a domestic corporation may claim deemed-paid foreign tax credits with respect to a foreign corporation held indirectly through a foreign or domestic partnership, if the domestic corporation constructively owns 10% or more of the foreign corporation’s voting stock. Both individual and corporate partners (or estate or trust beneficiaries) may claim direct foreign tax credits with respect to their proportionate shares of taxes paid or accrued by a partnership (or estate or trust).

**Residence in a United States Possession**
I.R.C. §937; Act §908
Effective for tax years ending after October 22, 2004; except that the 183-day rule applies to tax years beginning after October 22, 2004.

**Background**
A resident alien is generally taxed in the same manner as a U.S. citizen. In contrast, a nonresident alien is generally subject to U.S. tax only on certain gross U.S. source income at a flat 30% rate (unless such rate is eliminated or reduced by treaty) and on net income that has a sufficient nexus to the United States at the graduated rates applicable to U.S. citizens and residents under I.R.C. §1.

An alien is considered a resident of the United States if the individual:

1. Has entered the United States as a lawful permanent resident and is such a resident at any time during the calendar year,
2. Is present in the United States for a substantial period of time (the so-called “substantial presence test”), or
3. Makes an election to be treated as a resident of the United States (I.R.C. §7701(b)).
An alien who does not meet the definition of a “resident alien” is considered to be a non-resident alien for U.S. income tax purposes.

For purposes of the substantial presence test, the United States includes the states and the District of Columbia, but does not include U.S. possessions.

New Law
New I.R.C. §937 provides that the term “bona fide resident” means a person who meets a two-part test with respect to Guam, American Samoa, the Northern Mariana Islands, Puerto Rico, or the Virgin Islands for the taxable year.

- An individual must be present in the possession for at least 183 days in the taxable year.
- An individual must not have a tax home outside the possession during the taxable year and not have a closer connection to the U.S. or a foreign country during the year.

Treasury may create exceptions to these general rules to cover persons whose presence outside a possession for extended periods of time lacks a tax avoidance purpose, such as military personnel, workers in the fisheries trade, and retirees who travel outside the possession for personal reasons. A taxpayer must file a notice in the first taxable year bona fide residence in a possession is claimed. Any income treated as U.S. source income or as effectively connected with the conduct of a U.S. trade or business is not treated as income from within any possession or as effectively connected with a trade or business within any possession.

CFC Dividends-Received Deduction
I.R.C. §965; Act §422
Effective for tax years ending on or after October 22, 2004

Background
Income earned by a U.S. domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until repatriation, the U.S. tax on the income generally is deferred. This provides an incentive not to repatriate foreign-source earnings and profits.

New Law
The Jobs Act of 2004 provides a one tax year incentive for reinvesting foreign earnings in the United States. Dividends received by a U.S. corporation from controlled foreign corporations are eligible for an 85% dividends-received deduction under new I.R.C. §965. The corporation may elect the deduction for either its first taxable year beginning on or after enactment or during its last taxable year beginning before enactment. The election is to be made on a timely filed return (including extensions). The deduction is not allowed for dividends received in any taxable year beginning one year or more after enactment.

Planning Pointer—Window of Opportunity. The committee reports noted that there is no intent to make this measure permanent or to extend or enact it again in the future. Because only 15% of the income is taxable, the highest effective tax rate will be only about 5% on the repatriated and reinvested income.

- The dividends must be described in a domestic reinvestment plan, approved by the taxpayer’s senior management and board of directors, that provides for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation. The reinvestment plan cannot designate repatriated funds for use as payment for executive compensation.

- No foreign tax credit or deduction is allowed for foreign taxes attributable to the deductible portion of any dividend. The taxpayer may specifically identify which dividends are treated as carrying the deduction and which dividends are not. The income attributable to the nondeductible portion of a qualifying dividend may not be offset by expenses, losses or deductions, and the tax attributable to such income generally may not be offset by credits other than foreign tax credits and AMT credits.
The tax on this amount also cannot reduce the alternative minimum tax that otherwise would be owed by the taxpayer. However, the deduction is not treated as a preference item for AMT. Thus, the deduction is allowed in computing alternative minimum taxable income, notwithstanding the fact that it may not be deductible in computing earnings and profits.

### Prevention of Interest Mismatching with Related Foreign Persons

I.R.C. §§163(e), 267; Act §841
Effective for payments accrued on or after October 22, 2004

**Background**

Certain anti-deferral regimes may cause a U.S. shareholder of a foreign corporation to be taxed on a current basis in the United States with respect to certain categories of income earned by the foreign corporation that have not been paid out as dividend. The main anti-deferral regimes are the controlled foreign corporation rules of subpart F, the passive foreign investment company rules, and the foreign personal holding company rules.

Generally, a deduction is allowed for all interest paid or accrued within the taxable year, including the aggregate daily portions of OID of the issuer. However, if a debt instrument is held by a related foreign person, the OID is not allowable as a deduction until paid.

**New Law**

The Jobs Act of 2004 provides that deductions are allowable for interest and OID amounts accrued but unpaid to related foreign corporations to the extent that the amounts accrued by the payor are, for U.S. tax purposes, currently includible in the income of the direct or indirect U.S. owners of the related foreign corporation under the relevant inclusion rules.

### Corporate Tax on International Shipping Activities

I.R.C. §§1352 through 1359; Act §248
Effective for tax years beginning after October 22, 2004

**Background**

The United States imposes a 4% tax on the amount of a foreign corporation’s U.S. gross transportation income (I.R.C. §887). Transportation income includes income from the use (or hiring or leasing for use) of a vessel and income from services directly related to the use of a vessel. Fifty percent of the transportation income attributable to transportation that either begins or ends (but not both) in the United States is treated as U.S. source gross transportation income.

**New Law**

A new subchapter R is added to the Internal Revenue Code (§§1352 through 1359), effective for taxable years beginning after enactment. Corporations may elect to apply the highest I.R.C. §11 tax to their notional shipping income, based on net tonnage of their qualifying vessels. No deductions or credits are allowed.

### Interest Deduction Barred for Nondisclosed Transactions

I.R.C. §163; Act §838
Effective for taxable years beginning after October 22, 2004

**Background**

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness, including interest attributable to an underpayment of federal tax. Individuals may not deduct personal interest, with limited exceptions for qualifying home mortgage interest and investment interest expense.

**New Law**

The Jobs Act of 2004 provides that no deduction is allowed for interest paid or accrued on an underpayment of tax attributable to an under-
Statement arising from an undisclosed listed transaction or from an undisclosed reportable avoidance transaction.

**Background**

There is no specific penalty for failing to disclose a reportable transaction; however, a failure to disclose can jeopardize a taxpayer’s ability to claim (a) that any income tax understatement attributable to the undisclosed transaction is due to reasonable cause, and (b) that the taxpayer acted in good faith.

**New Law**

The Jobs Act of 2004 imposes a new penalty under I.R.C. § 6707A on any person who fails to include with any return or statement any required information with respect to a reportable transaction under I.R.C. § 6011.

- The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.
- The penalty for failing to disclose a reportable transaction is $10,000 for a natural person and $50,000 for other persons. It increases to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction.
- The penalty cannot be waived with respect to a listed transaction. For reportable transactions, the IRS commissioner or his delegate can rescind the penalty only if rescission would promote compliance with the tax laws and effective tax administration. There is no taxpayer right to judicially appeal a refusal to rescind a penalty.
- The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.
- A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction or a non-disclosed reportable avoidance transaction) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission, without regard to whether the taxpayer determines the amount.

**Practitioner Note—Reportable Transactions**

Treas. Reg. §1.6011-4(b) describes six categories of reportable transactions:

1. “Listed transactions” (or similar transactions) specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance.
2. Any transaction that is offered under conditions of confidentiality.
3. Any transaction for which (a) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained, or (b) the fees are contingent on the intended tax consequences being sustained.
4. Any transaction resulting in a taxpayer claiming a loss (under I.R.C. §165) of (a) at least $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (b) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (c) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.
5. Any transaction done by SEC reporting companies or businesses with $250 million or more in net assets in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.
6. Any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.

**Failure to Disclose Reportable Transaction Penalty**

I.R.C. §6707A; Act §811

Effective for returns and statements due after October 22, 2004
of the penalty to be material to the reports in which the penalty must appear.

Accuracy-Related Penalty for Listed Transactions

I.R.C. §§6662, 6662A; Act §812
Effective for tax years ending after October 22, 2004

Background

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the liability is understated by the greater of 10% of the correct tax or $5,000 ($10,000 for corporations), a substantial understatement exists. A penalty may be imposed equal to 20% of the underpayment of tax attributable to the understatement. The penalty is not imposed if (1) the treatment of the item is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters. The penalty may be avoided if a non-corporate taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. The understatement penalty generally is abated (even with respect to tax shelters) when the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

New Law

The Jobs Act of 2004 modifies the I.R.C. §6662 accuracy-related penalty by replacing the rules applicable to tax shelters with a new I.R.C. §6662A accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose. The penalty rate and defenses vary, depending on whether the transaction was adequately disclosed.

- In general, a 20% accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.
- The only exception is if the taxpayer satisfies a more stringent reasonable cause and good faith exception, which is available only if (1) the relevant facts affecting the tax treatment are adequately disclosed, (2) there is or was substantial authority for the claimed tax treatment, and (3) the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.
- A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion provided by a material advisor (explained later under “Disclosure of Reportable Transactions.”).
- If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available and the taxpayer is subject to an increased penalty equal to 30% of the understatement.
- The understatement is determined as the sum of the product of the highest corporate or individual tax rate (as appropriate) and the income difference between the taxpayer’s treatment of an item and the proper tax treatment of the item, and any decrease in the aggregate amount of credits.

Tax Shelter Exception to Confidentiality

I.R.C. §7525; Act §813
Effective for communications made on or after October 22, 2004

Background

A common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. I.R.C. §7525 provides that, with respect to tax advice, the common law protections apply to a communication between a
taxpayer and a federally authorized tax practitioner. This rule is inapplicable to communications regarding corporate tax shelters.

**New Law**
The Jobs Act of 2004 provides that communications with respect to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity, are not subject to the confidentiality provision that otherwise applies to a tax advice communication between a taxpayer and a federally authorized tax practitioner.

**Statute of Limitations**
I.R.C. §6501; Act §814
Effective for open years as of October 22, 2004

**Background**
In general, taxes must be assessed within three years after the date a return is filed. If there is a substantial omission of items of gross income that total more than 25% of the gross income shown on the return, the assessment period is extended to six years. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all. If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time.

**New Law**
The Jobs Act of 2004 extends the statute of limitations for assessment with respect to a listed transaction if a taxpayer fails to include on any return or statement for any taxable year any information that is required to be included under I.R.C. §6011. The statute of limitations for assessment will not expire earlier than one year after the earlier of the date the information is furnished or the date that a material advisor satisfies the list maintenance requirements of I.R.C. §6112.

**Example 12. Transaction Later Becomes Listed**
Tex Trimmer engaged in a transaction in 2002 that becomes a listed transaction in 2005. If Tex fails to disclose the transaction in the manner required by Treasury regulations, the transaction is subject to the extended statute of limitations.

**Disclosure of Reportable Transactions**
I.R.C. §§6111, 6112, 6708; Act §815
Effective for material aid, assistance or advice provided after October 22, 2004

**Background**
An organizer of a tax shelter is required to register the shelter with the IRS not later than the day the shelter is first offered for sale.

**New Law**
The Jobs Act of 2004 repeals the current I.R.C. §6111 rules for registration of tax shelters. Instead, each material advisor with respect to a reportable transaction must timely file an information return identifying and describing the transaction, any potential tax benefits expected to result from it, and any other information the secretary may prescribe.

A material advisor means any person who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who directly or indirectly derives gross income for such assistance or advice in excess of $250,000 ($50,000 if substantially all of the tax benefits are provided to natural persons) or another amount as prescribed by the secretary. A material advisor also includes any person who provides material aid, assistance, or advice with respect to insuring any reportable transaction and who derives gross income for the assistance or advice as specified.

In addition, the current I.R.C. §6112 list maintenance rules are replaced with a requirement for each material advisor to maintain a list that identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and contains other information as required by the secretary.
**Penalty for Failing to Furnish Information**  
I.R.C. §6707; Act §816  
Effective for returns due after October 22, 2004

**Background**  
The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of 1% of the aggregate amount invested in the shelter or $500. If the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50% of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75% of the applicable fees. I.R.C. §6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

**New Law**  
The Jobs Act of 2004 amends I.R.C. §6707 to imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction). The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of $200,000 or 50% of the gross income of the person received with respect to the aid, assistance, or advice before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a listed transaction increases the penalty to 75% of the gross income. The penalty cannot be waived with respect to a listed transaction. For reportable transactions, the penalty can be rescinded (or abated) only in exceptional circumstances. The IRS is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

**Penalty for Failing to Maintain Lists**  
I.R.C. §6708; Act §817  
Effective for list requests made after October 22, 2004

**Background**  
Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required. I.R.C. §6708 imposes a penalty of $50 for each name omitted from the list, with a maximum penalty of $100,000 per year.

**New Law**  
The Jobs Act of 2004 modifies the penalty by making it a time-sensitive penalty for list requests made after enactment. A material advisor who is required to maintain an investor list and who fails to make the list available upon written request by the secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has maintained a list but does not make the list available to the secretary. It can be waived due to reasonable cause.

**Penalty on Promoters of Tax Shelters**  
I.R.C. §6700; Act §818  
Effective for activities occurring after October 22, 2004

**Background**  
A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in an arrangement if, in connection with such activity, the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement. The amount of the penalty is $1,000 (or, if the person establishes that it is less, 100% of the gross income derived or to be derived by the person from such activity).
New Law
The Jobs Act of 2004 modifies the $1,000 penalty for false or fraudulent statements to equal 50% of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that the statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

Substantial Understatement Penalty for Nonreportable Transactions
I.R.C. §6662; Act §819
Effective for taxable years beginning after enactment

Background
A 20% accuracy-related penalty applies to any substantial understatement of tax. A “substantial understatement” exists if the correct income tax liability for a taxable year exceeds the reported liability by the greater of 10% of the correct tax or $5,000 ($10,000 in the case of most corporations).

New Law
The Jobs Act of 2004 modifies the definition of “substantial” for corporate taxpayers. A corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of 10% of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or $10 million.

Actions to Enjoin Certain Conduct
I.R.C. §7408; Act §820
Effective on October 23, 2004

Background
I.R.C. §7408 authorizes civil actions to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.

New Law
The Jobs Act of 2004 authorizes actions to enjoin a material advisor from failing to file an information return with respect to a reportable transaction, from failing to maintain (or to timely furnish upon written request) a list of investors with respect to each reportable transaction, or from violating any of the rules under Circular 230, which regulates the practice of representatives of persons before the Department of the Treasury.

Failure to Report Interests in Foreign Financial Accounts
31 U.S.C. §5231; Act §821
Effective for failures to report after October 22, 2004

Background
Individuals must answer questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B (Form 1040). Taxpayers who answer “yes” in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. A civil penalty may be imposed on any person who willfully violates this reporting requirement. It is equal to the amount of the transaction or the value of the account, up to a maximum of $100,000. The minimum amount of the penalty is $25,000.

New Law
The Jobs Act of 2004 imposes a civil penalty of up to $10,000 without regard to willfulness. It may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report. The civil penalty for willful behavior is amended to the greater of $100,000 or 50% of the amount of the transaction or account.

Regulation of Individuals Practicing before Treasury
31 U.S.C. §330(b); Act §822
Effective for actions after October 22, 2004

Background
The secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury, and to suspend or
disbar from practice before the department a representative who is incompetent, who is disreputable, who violates the rules regulating practice, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the secretary pursuant to this provision are contained in Circular 230.

**New Law**
The Circular 230 sanctions are modified in two ways. Censure is expressly permitted as a sanction. In addition, a monetary penalty may be imposed as a sanction on the representative and on the entity for which he was acting if the entity knew, or reasonably should have known, of the conduct. The monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. They may be in addition to, or in lieu of, any suspension, disbarment, or censure.

**Partial Payment Installment Agreements**
I.R.C. §6159; Act §843
Effective on October 22, 2004

**Background**
The IRS may enter into written agreements allowing a taxpayer to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed. Prior to 1998, the IRS entered into installment agreements that provided for partial payment (rather than full payment) of the total amount owed over the period of the agreement. In that year, the IRS Chief Counsel issued a memorandum concluding that partial payment installment agreements were not permitted.

**New Law**
The Jobs Act of 2004 authorizes the IRS to enter into installment agreements that do not provide for full payment of the taxpayer’s liability over the life of the agreement. The IRS must review partial payment installment agreements at least every two years to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

**Observation—Benefit for Client.** A partial pay installment agreement may be advantageous for a client whose current income does not permit payment of a liability within the statute of limitations. Because the payments can be adjusted if the client’s financial circumstances change, the IRS may be likely to accept the agreement than it would an offer in compromise. In addition, installment agreements are not public records.

**Increase in Continuous Levy on Payments to Vendors to Federal Government**
I.R.C. §6331(h); Act §887
Effective for levies on or after October 22, 2004

**Background**
If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person. A continuous levy is applicable to specified federal payments including a payment to a vendor of goods or services to the government is subject to continuous levy. This continuous levy attaches up to 15% of any specified payment due the taxpayer.

**New Law**
The Jobs Act of 2004 permits a levy of up to 100% of a federal payment to a vendor of goods or services to the federal government.

**Private Sector Companies to Collect Tax Debts**
I.R.C. §6306; Act §881
Effective on October 22, 2004

**New Law**
In general, federal agencies are permitted to enter into contracts with private debt collection companies for collection services to recover indebtedness owed to the United States. That
provision does not apply to debts under the Internal Revenue Code.

**Observation——Pilot Project.** In fiscal years 1996 and 1997, Congress earmarked $13 million for IRS to test the use of private debt collection companies. Private debt collectors assisted in locating and contacting taxpayers, reminding them of their outstanding tax liability, and suggesting payment options. If the taxpayer agreed to make a payment, the taxpayer was transferred to the IRS. The private companies were paid a flat fee for services rendered rather than an amount based on collections. The pilot was discontinued after disappointing results: GAO reported that IRS collected $3.1 million attributable to the private company efforts; expenses were also $3.1 million. In addition, there were lost opportunity costs of $17 million because IRS collection personnel were diverted from their usual collection responsibilities to work on the pilot.

**New Law**

The IRS may use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type and to arrange payment of those taxes by the taxpayers.

- Provisions of the Fair Debt Collection Practices Act apply to the private company, and taxpayer protections that are statutorily applicable to the IRS and its employees are also statutorily applicable to the private sector debt collection companies and their employees.
- Subcontractors are prohibited from having contact with taxpayers, providing quality assurance services, and composing debt collection notices. Any other service provided by a subcontractor must receive prior approval from the IRS.
- In addition, it is intended that the IRS require the private sector debt collection companies to inform every taxpayer they contact of the availability of assistance from the Taxpayer Advocate.
- A revolving fund is created from the amounts collected by the private debt collection companies. The private companies will be paid out of this fund. The new law prohibits the payment of fees for all services in excess of 25% of the amount collected under a tax collection contract. Up to 25% of the amount collected may be used for IRS collection enforcement activities.
- Treasury must provide a biennial report to Congress, and the conferees expect that, consistent with best management practices and sound tax administration principles, the secretary will utilize this new debt collection provision to the maximum extent feasible.

**Effective in 2005**

**Charitable Contributions of Vehicles**

I.R.C. §170(f); Act §884
Effective for contributions made after December 31, 2004

**Background**

Under prior law a taxpayer who donates a used automobile to a charitable donee generally deducts the fair market value (rather than the taxpayer’s basis) of the automobile. A taxpayer who donates a used automobile generally is permitted to use an established used car pricing guide to determine the fair market value of the automobile, but only if the guide lists a sales price for an automobile of the same make, model and year, sold in the same area, and in the same condition as the donated automobile. Similar rules apply to contributions of other types of vehicles and property, such as boats.

Charities are required to provide donors with written substantiation of donations of $250 or more. Taxpayers are required to report non-cash contributions totaling $500 or more and the method used for determining fair market value.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach the appraisal to the tax return in certain cases.

**New Law**

For contributions after 2004, a charitable deduction of more than $500 for the contribution of a vehicle is allowable only if the taxpayer obtains
a contemporaneous written acknowledgement. This applies to motor vehicles manufactured primarily for use on public roads, boats, and aircraft, except inventory property.

- The acknowledgement must contain the name and taxpayer identification number of the donor and the vehicle identification number (or similar number) of the vehicle.
- If the donee sells the vehicle without a significant intervening use or material improvement, the acknowledgement must certify that the vehicle was sold in an arm’s length transaction between unrelated parties, state the gross proceeds from the sale, and provide that the deductible amount may not exceed the gross proceeds.
- Otherwise, the acknowledgement must certify the intended use or material improvement of the vehicle and the intended duration of such use, and certify that the vehicle will not be transferred in exchange for money, other property, or services before completion of such use or improvement.
- An acknowledgement is contemporaneous if provided within 30 days after the sale of a vehicle that is not significantly improved or materially used by the donee, or, in all other cases, within 30 days after the contribution.
- The donee must file an information report as required by Treasury. A penalty applies under new IRC §6720 if a donee organization knowingly furnishes a false or fraudulent acknowledgement, or knowingly fails to furnish an acknowledgement in the manner, at the time, and showing the required information. For a qualified vehicle sold without a significant intervening use or material improvement, the penalty is the greater of the gross proceeds from the sale, and the requirement that the donee certify that the vehicle will not be transferred in exchange for money, other property, or services before completion of a significant use or material improvement by the donee. Such guidance may be appropriate if an organization directly furthers its charitable purposes by selling automobiles to needy persons at a price significantly below fair market value, the committee reports note.

**Example 13. Deliver Meals**

As part of its regularly conducted activities, an organization delivers meals to needy individuals. The use requirement would be met if the organization actually used a donated qualified vehicle to deliver food to the needy. Use of the vehicle to deliver meals substantially furthers a regularly conducted activity of the organization.

However, the use also must be significant, which depends on the nature, extent, and frequency of the use. If the organization used the vehicle only once or a few times to deliver meals, the use would not be considered significant. If the organization used the vehicle to deliver meals every day for one year the use would be considered significant. If the organization drove the vehicle 10,000 miles while delivering meals, such use likely would be considered significant. However, use of a vehicle in such an activity for one week or for several hundreds of miles generally would not be considered a significant use.

**Example 14. Transport Volunteers**

An organization uses a donated qualified vehicle to transport its volunteers. The use would not be significant merely because a volunteer used the vehicle over a brief period of time to drive to or from the organization’s premises. On the other hand, if at the time the organization accepts the contribution of a qualified vehicle, the organization intends to use the vehicle as a regular and ongoing means of transport for volunteers of the organization, and such vehicle is so used, then the significant use test likely would be met.
Example 15. Transport Residents

A taxpayer makes a charitable contribution of a used automobile in good running condition and that needs no immediate repairs to a charitable organization that operates an elder care facility. The donee organization accepts the vehicle and immediately provides the donor a written acknowledgment containing the name and TIN of the donor, the vehicle identification number, a certification that the donee intends to retain the vehicle for a year or longer to transport the facility’s residents to community and social events and deliver meals to the needy, and a certification that the vehicle will not be transferred in exchange for money, other property, or services before completion of such use by the organization.

A few days after receiving the vehicle, the donee organization commences to use the vehicle three times a week to transport some of its residents to various community events, and twice a week to deliver food to needy individuals. The organization continues to regularly use the vehicle for these purposes for approximately one year and then sells the vehicle. Under the provision, the donee’s use of the vehicle constitutes a significant intervening use prior to the sale by the organization, and the donor’s deduction is not limited to the gross proceeds received by the organization.

Background

Like many other countries, the United States has long provided export-related benefits under its tax law. For several years, these benefits were provided under the foreign sales corporation (FSC) regime. In 2000, the European Union (EU) succeeded in having the FSC regime declared a prohibited export subsidy by the World Trade Organization (WTO). In response to this WTO finding, the United States repealed the FSC rules and enacted a new regime, an Extraterritorial Income Exclusion (ETI). Under the ETI regime, an exclusion from gross income applies with respect to extraterritorial income (gross income attributable to foreign trading gross receipts). The EU immediately challenged the ETI regime in the WTO, and in January 2002 the WTO appellate body held that the ETI regime also constituted a prohibited export subsidy under the trade agreements. Tariffs have been imposed on many U.S. products.

New Law

The Jobs Act of 2004 repeals the ETI regime. However, partial exclusions are allowed for two transition years: There is a 20% income inclusion for calendar year 2005 transactions, and a 40% income inclusion for 2006 transactions. In addition, an exception applies to transactions under a binding contract (purchase, renewal or replacement options) with an unrelated person that was in effect on September 17, 2003. Foreign corporations that had elected under I.R.C. §943(e) to be taxed as domestic corporations have one year from October 22, 2004 to revoke that election without recognition of gain or loss.

Charitable Contributions by Whalers

I.R.C. §170(n); Act §335

Effective for contribution made after December 31, 2004

New Law

Expenses paid by recognized whaling captains in support of native Alaskan subsistence whaling are deductible under IRC §170. There is a $10,000 annual limit.

Repeal of Exclusion for Extraterritorial Income

I.R.C. §114; Act §101

Effective for transactions after December 31, 2004

Practitioner Note—EU Response

EU Trade Commissioner Pascal Lamy praised the repeal and said the EU will study the new law to determine if it complies with EU rules. http://europa.eu.int/comm/trade/issues/respectrules/dispute/pr111004_en.htm
Deduction for Income Attributable to Domestic Production Activities

I.R.C. §199; Act §102
Effective for tax years beginning after December 31, 2004

Background
Under present law, there is no provision that reduces a business’s income tax for taxable income attributable to domestic production activities.

New Law
The Jobs Act of 2004 permits an additional tax deduction for manufacturing or other production in the U.S. (including farming), limited to 50% of the employer’s Form W-2 wages (box 1 plus elective deferrals to retirement plans).

- The deduction is based on the lesser of qualified production activities income or taxable income. It will be phased in at 3% in 2005 and 2006, and 6% in 2007, 2008 and 2009, reaching 9% in 2010.

- Qualified production activities income is domestic production gross receipts minus cost of goods sold, direct expenses and an allocable share of indirect expenses.

- Domestic production gross receipts are receipts derived from the sale, lease, rental, exchange or other disposition of qualifying production property, plus the production (but not the transmission or distribution) of electricity, natural gas and potable water. The term also includes receipts from construction performed in the U.S. and engineering or architectural services for those construction projects. However, sales of food and beverages at a retail establishment are excluded.

- Qualifying production property is tangible personal property or computer software that was manufactured, produced, grown or extracted in whole or insignificant part within the U.S. It includes sound recordings and qualifying films (films for which at least 50% of the compensation paid to all personnel is for services performed in the U.S.) Sexually explicit films are excluded.

- The deduction is permitted for alternative minimum tax.

- The disposition must be to an unrelated person, applying both the work opportunity credit rules and the pension plan rules for businesses under common control.

- Affiliated groups are treated as a single corporation, using a 50% rather than an 80% criteria and including insurance companies and corporations with a possessions tax credit election.

- The deduction is a separately stated item for partnerships, S corporations, estates and trusts. The Schedule K-1 recipient will be treated as having paid an allocable share of the entity’s wages.

- Similar rules apply for patrons of agricultural or horticultural cooperatives. When patronage dividends based on qualifying production are includible in income, the patron will be allowed the deduction.

- Taxpayers who had elected under IRC §631(a) to treat the cutting of timber as a sale or exchange may revoke that election for tax years ending after the date of enactment. A subsequent election will be allowed.

Practitioner Note—Commissioner Notes Complexity. The computation of the deduction relating to income attributable to domestic production activities will be figured on a new form for 2005 that is expected to be at least 10 lines. The instructions for the new form are likely be at least three pages. In addition, two additional lines will be added to each 2005 business or farm form or schedule on which the deduction can be claimed.

In a letter to the Joint Committee on Taxation, reprinted in the Congressional Record, IRS Commissioner Mark Everson noted that the new deduction will require extensive, detailed guidance, addressing (among other issues):
1. Which activities constitute production activities;
2. Statutory exceptions to the definition of production activity;
3. Allocation of revenues between production and non-production activities;
4. Allocation of deductions between production and non-production activities; and
5. Application of the provision when related and unrelated taxpayers perform parts of the production activity. (Continued)
Effectiv in 2005

S Corporations
I.R.C. §§1361, 1362, 1366; Act §§231, 232 and 234 through 239
Generally effective for tax years beginning after December 31, 2004

Background
An S corporation may have no more than 75 shareholders. A husband and a wife, and their estates, are counted as a single shareholder. Suspended losses may not be transferred. Banks may be S corporations, but the passive investment income restrictions apply.

New Law
- The Jobs Act of 2004 increases the limit on the number of shareholders to 100. However, the allowable increase is actually larger, because members of a family may elect to be counted as one shareholder. Members of a family include a common ancestor, his or her lineal descendants for up to 6 generations, and their spouses or former spouses. When the first member of the next generation (the great-great-great-great-grandchild) is born, the first individual is no longer considered a common ancestor. Adopted children are treated as related by blood.
- The election is to be made under regulations to be issued; once made, it is in effect until it is terminated under the regulations. Relief from an inadvertent invalid election or termination is provided.
- Potential current beneficiaries of electing small business trusts (EBSTs) do not include potential beneficiaries under an unexercised power of appointment. If the EBST disposes of its S corporation stock, the 60-day period for disregarding potential beneficiaries who are ineligible shareholders is extended to one year before the disposition.
- If stock is transferred between spouses or incident to divorce (I.R.C. §1041 transactions), the transferee succeeds to any suspended losses or deductions that were being carried over because of basis limitations.
- Disposition of S corporation stock by a qualified subchapter S trust (QSST) is treated as a disposition by the beneficiary for the at-risk rules and the passive loss rules.
- For banks, bank holding companies and financial holding companies, interest income and dividends paid on legally required holdings are not included in the definition of passive investment income for termination of S status (the 25% of gross income for 3 consecutive years’ test).
- If a QSub election is inadvertently invalid or terminated, relief can be granted under the same criteria as for S corporation elections.
- IRS may issue guidance on filing of information returns by QSubs.

Everson explained that by distinguishing production from other activities, the new law “places considerable tension on defining terms and designing anti-abuse rules.” Because benefits are provided to production activities over other aspects of a taxpayer’s business, “taxpayers naturally will classify everything possible as production activities. Audits, particularly those involving integrated businesses, will have to focus on classification and the allocation of income and costs.” The IRS commissioner also stated that “Many businesses, particularly small businesses, will find it difficult to understand and comply with these complex new rules, which will affect not only the computation of a taxpayer’s regular tax liability but also its alternative minimum tax liability. It will be difficult, if not impossible, for the IRS to craft simplified provisions tailored to small businesses or other taxpayers.

Taxpayers will be required to devote substantial additional resources to meeting their tax responsibilities, including not only employees and outside tax advisers, but also recordkeeping and systems modification resources.”

Explaining that the resulting costs will reduce significantly the tax benefits, he predicted that “Some small businesses may find that the additional costs outweigh the benefits, particularly during the initial phase-in period.”
Withholding from Supplemental Wage Payments

No I.R.C. §; Revenue Reconciliation Act of 1993 §13273; Act §904
Effective for payments made after December 31, 2004

Background
In some cases, “supplemental” wage payments (e.g., bonuses or commissions) may be subject to withholding at a flat rate, based on the third lowest income tax rate under the Code (25% for 2005).

New Law
Once annual supplemental wage payments to an employee exceed $1 million, any additional supplemental wage payments to the employee in that year are subject to withholding at the highest income tax rate (35% for 2004 and 2005), regardless of any other withholding rules and regardless of the employee’s Form W-4. Other types of withholding (such as pension withholding and backup withholding) are not affected.

Nonqualified Deferred Compensation Plans

I.R.C. §409A; Act §885
Effective for amounts deferred after December 31, 2004, with some exceptions.

Background
In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual’s rights are transferable or not subject to a substantial risk of forfeiture.

New Law
New IRC §409A governs income deferral under nonqualified plans after 2004.

- All amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent they not subject to a substantial risk of forfeiture and were not previously included in gross income unless certain requirements are satisfied.
- In addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.
- The amount required to be included in income is also subject to a 20% additional tax.
- Current income inclusion, interest, and the additional tax apply only with respect to the participants with respect to whom the requirements of I.R.C. §409A are not met, rather than to all plan participants.
- Distributions are allowed only upon separation from service, death, a specified time (or pursuant to a fixed schedule), change in control of a corporation, occurrence of an unforeseeable emergency, or if the participant becomes disabled. If an employee separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. It is intended that the secretary will provide other, limited, exceptions, such as when a distribution is needed in order to comply with a court-approved settlement incident to divorce.
- The participant’s deferral election must be made no later than the close of the preceding taxable year or as provided in Treasury regulations. In the case of performance-based compensation based on services performed over a period of at least 12 months, the election may be made no later than 6 months before the end of the service period.
- If assets are set aside (directly or indirectly) in a trust (or other arrangement) located outside of the United, the assets are treated as property transferred in connection with the performance of services under I.R.C. §83 (whether or not they are available to satisfy
the claims of general creditors) at the time they are set aside or transferred outside of the United States. Any subsequent increases in the value of (or any earnings with respect to) such assets are treated as additional transfers of property. The provision does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction.

- A transfer of property under I.R.C. §83 also is triggered if the plan provides that upon a change in the employer’s financial health, assets will be restricted to the payment of nonqualified deferred compensation (such as by transfer to a rabbi trust).

- I.R.C. §409A is not intended to apply when assets are restricted for a reason other than change in financial health (e.g., upon a change in control) or if assets are periodically restricted under a structured schedule and scheduled restrictions happen to coincide with a change in financial status. Any subsequent increases in the value of (or any earnings with respect to) restricted assets are treated as additional transfers of property.

- I.R.C. §409A is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. Any amount included in gross income under the provision is not be required to be included in gross income under any provision of law later than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer’s deduction for nonqualified deferred compensation.

- Amounts required to be included in income under I.R.C. §409A and amounts that are deferred are subject to reporting and federal income tax withholding requirements, including reporting on Form W-2 (or Form 1099) for the year includible in income. (The application of the provision is not limited to arrangements between an employer and employee.)

- I.R.C. §409A is effective for amounts deferred in taxable years beginning after 2004. Amounts deferred in taxable years beginning before 2005 are subject to §409A if the plan under which the deferral is made is materially modified after October 3, 2004. Earnings on amounts deferred before the effective date are subject to I.R.C. §409A to the extent that the deferred amounts are subject to I.R.C. §409A. An amount is considered deferred before 2005 if the amount is earned and vested before such date.

- No later than 60 days after enactment, the secretary shall issue guidance providing a limited period of time during which a non-qualified deferred compensation plan adopted before December 31, 2004, may be amended (1) to provide that a participant may terminate participation in the plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, if such amounts are includible in income of the participant as earned, or if later, when not subject to a substantial risk of forfeiture, and (2) to conform with IRC §409A with respect to amounts deferred after December 31, 2004.

### Aircraft Bonus Depreciation

I.R.C. §168(k); Act §336
Effective for aircraft placed in service before January 1, 2006

**New Law**

The placed-in-service date to qualify for bonus depreciation (I.R.C. §168(k)) is extended to include certain non-commercial aircraft placed in service in 2005. Qualifying aircraft cannot be used in the trade or business of transporting persons or property (except for agricultural or firefighting purposes). The purchaser, at the time of the contract for purchase, must have made a nonrefundable deposit of the lesser of 10% of the cost or $100,000, and the aircraft must have an estimated production period exceeding 4 months and a cost exceeding $200,000.

### Standing Timber Sales

I.R.C. §631(b); Act §315
Effective for sales after December 31, 2004
Background

A taxpayer disposing of timber held for more than one year is eligible for capital gains treatment in three situations.

1. If the taxpayer sells or exchanges timber that is a capital asset (I.R.C. §1221) or property used in the trade or business (I.R.C. §1231), the gain generally is long-term capital gain; however, if the timber is held for sale to customers in the taxpayer’s business, the gain will be ordinary income.

2. If the taxpayer disposes of the timber with a retained economic interest, the gain is eligible for capital gain treatment (I.R.C. §631(b)).

3. If the taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (I.R.C. §631(a)).

New Law

Timber owners may elect under IRC §631(b) to treat timber held for more than 1 year that is sold before it is cut as sold on the payment date, whether it is an outright sale or an economic interest is retained.

Qualified Green Bonds

I.R.C. §142(a); Act §701
Effective for bonds issued after December 31, 2004

New Law

A new category of private activity bonds can be issued by state and local governments to finance a project designated as a green building and sustainable design project. At least 75% of the square footage of the commercial buildings that are part of the project must be registered and expected to qualify for the U.S. Green Building Council’s LEED certification; the project must include a brownfield site; it must receive at least $5 million dollars in specific state or local resources; and it must include at least one million square feet of building or at least 20 acres of land. There is a national limit of $2 billion of qualified green bonds to be issued after 2004 and before October 1, 2009.

Brownfield Sale Exclusion from UBIT

I.R.C. §512(b); Act §702
Effective for disposition of property acquired by the taxpayer after December 31, 2004 and before January 1, 2010

New Law

Gain or loss from the qualified sale, exchange, or other disposition of a qualifying brownfield property will be excluded from unrelated business taxable income (UBTI) for an exempt organization that (alone or as a partner) acquires, remediates, and disposes of the qualifying brownfield property. An exception from the debt-financed property rules also applies to such properties. However, the exclusion does not apply to an amount treated as gain that is ordinary income with respect to I.R.C. §1245 or I.R.C. §1250 property, including any amount deducted as an I.R.C. §198 expense. Property need not be disposed of by the termination date to qualify for the exclusion.

Life Insurance Companies

I.R.C. §815(g); Act §705
Effective for tax years beginning after December 31, 2004 and before January 1, 2007

Background

Before 1983, a life insurance company could defer paying income tax on some gains from operations until they were distributed to stockholders. The untaxed amounts were accounted for in a policyholder surplus account. Under the law in effect before the Jobs Act of 2004, any direct or indirect distribution from an existing policyholder surplus account was subject to tax at the corporate rate when distributed. Prior law provided that any distribution to shareholders was treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

New Law

For tax years beginning in 2005 and 2006, the corporate income tax on distributions to shareholders from the policyholder surplus account of
a life insurance company is suspended, and any distributions are treated as first made out of the policyholder surplus account.

**Repeal of Special Rules for FASITs**

I.R.C. §§860H, 860I, 860J, 860K, 860L; Act §835

Generally effective on January 1, 2005

**Background**

In 1996 Congress created a new type of statutory entity called a financial asset securitization trust (FASIT) that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally is not taxable. Its taxable income or net loss flows through to its owner, generally required to be a single domestic C corporation.

**New Law**

The Jobs Act of 2004 repeals the special rules for FASITs and modifies the definition of a REMIC “regular interest.” The repeal generally does not apply to any FASIT in existence on October 22, 2004 to the extent that regular interests already issued by the FASIT remain outstanding in accordance with their original terms.

**Credit for Marginal Production of Oil and Gas**

I.R.C. §45I; Act §341

Effective for production in taxable years beginning after December 31, 2004

**New Law**

New IRC §45I provides a $3-per-barrel credit for crude oil and a $.50 credit per 1,000 cubic feet of qualified natural gas for holders of operating interests, for production from a domestic qualified marginal well in years beginning after 2004. The maximum amount of production on which the credit can claimed is 1,095 barrels or barrel equivalents. The credit is not available if the reference price of oil exceeds $18 ($2.00 for natural gas). It is reduced proportionately for reference prices between $15 and $18 ($1.67 and $2.00 for natural gas). If the production is eligible for the I.R.C. §29 credit (nonconventional source fuel credit), the marginal well credit is not allowable unless the taxpayer elects not to claim the I.R.C. §29 credit with respect to the well.

**Foreign Tax Credit and AMT**

I.R.C. §§53, 59; Act §421

Effective for tax years beginning after December 31, 2004

**Background**

Taxpayers are permitted to reduce their alternative minimum tax liability by an AMT foreign tax credit determined under principles similar to those used in computing the regular tax foreign tax credit. The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90 percent of AMT computed without any AMT net operating loss deduction and the AMT foreign tax credit.

**New Law**

The Jobs Act of 2004 eliminates the 90% limit on the AMT foreign tax credit. It may fully offset AMT for tax years ending after December 31, 2004.

**Translation of Foreign Taxes**

I.R.C. §986; Act §408

Effective for tax years beginning after December 31, 2004

**Background**

For accrual taxpayers, the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate.

**New Law**

The Jobs Act of 2004 provides that when foreign taxes are denominated in a currency other than the taxpayer’s functional currency, the taxpayer may elect to translate the taxes into U.S. dollar amounts using the exchange rates as of the time the taxes are paid instead of the average exchange rate for the year. An election applies to all subsequent taxable years unless it is revoked with IRS consent. Regulated investment companies that take income into account on an accrual
basis must translate the taxes into U.S. dollar amounts using the exchange rate as of the date the income accrues.

**Assets of Controlled Foreign Corporations**

I.R.C. §956; Act §407
Effective for CFC taxable years beginning after December 31, 2004

**Background**

In general, U.S. shareholders with a 10% or greater interest in a controlled foreign corporation (CFC) must include in taxable income their pro rata shares of certain income of the CFC when the income is earned, whether or not the earnings are distributed currently. In addition, the shareholders are subject to U.S. tax on their pro rata shares of the CFC’s earnings to the extent invested by the controlled foreign corporation in certain U.S. property in a taxable year. There currently are 11 specified exceptions from the definition of U.S. property.

**New Law**

The Jobs Act of 2004 adds two new exceptions in determining the current income inclusion by a U.S. 10% shareholder for an investment in U.S. property by a CFC: (1) Identified securities acquired and held by the CFC in the ordinary course of its trade or business as a dealer in securities; and (2) the CFC’s acquisition of certain debt obligations issued by a U.S. person that is not a domestic corporation. The new exceptions are effective for the CFC’s tax year beginning after 2004.

**Look-Through for CFC Sales of Partnership Interests**

I.R.C. §954; Act §412
Effective for CFC taxable years beginning after December 31, 2004

**Background**

If a CFC sells a partnership interest at a gain, the gain generally constitutes foreign personal holding company income and is included in the income of 10% U.S. shareholders of the CFC.

**New Law**

The Jobs Act of 2004 provides that a sale of a partnership interest by a CFC is treated as a sale of a share of the partnership assets for determining foreign personal holding company income, for partners who own (directly, indirectly, or constructively) at least 25% of a capital or profits interest in the partnership.

**Repeal of FPHC and FIC Rules**

I.R.C. §§551-558, 1246, 1247; Act §413
Effective for taxable years beginning after December 31, 2004

**Background**

Several sets of anti-deferral rules impose current U.S. tax on certain income earned by a U.S. person through a foreign corporation, including the controlled foreign corporation rules of subpart F, the passive foreign investment company rules, the foreign personal holding company rules, the personal holding company rules, the accumulated earnings tax rules, and the foreign investment company rules.

**New Law**

The Jobs Act of 2004 eliminates the foreign personal holding company (I.R.C. §§551-558) and foreign investment company (I.R.C. §§1246-1247) rules. Foreign corporations are excluded from the personal holding company rules, and personal services contract income subject to the present-law foreign personal holding company rules is included as subpart F foreign personal holding company income.

**FPHC Commodity Transactions**

I.R.C. §954; Act §414
Effective for taxable years beginning after December 31, 2004

**Background**

Gains or losses from commodity transactions are not treated as foreign personal holding company income if the transaction is a hedging transaction.

**New Law**

The Jobs Act of 2004 requires a hedging transaction to be clearly identified. The transaction must satisfy the general definition of a hedging
transaction under I.R.C. §1221(b)(2), modified to include any transaction with respect to a commodity by a CFC in the normal course of the CFC's trade or business that is made primarily to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in I.R.C. §1231(b) that is held by the CFC. Active business gains or losses from the sale of commodities qualify for exclusion from foreign personal holding company income if substantially all of the CFC’s commodities are comprised of stock in trade; depreciable property that is used in the trade or business; or supplies of a type regularly used or consumed by the CFC in the ordinary course of its trade or business.

**Extension of IRS Fees**

I.R.C. §7528(c); Act §891
Effective for requests made after December 31, 2004 and before October 1, 2014

**New Law**

IRS fees for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination that were authorized by statute for requests made through December 31, 2004 are extended for requests made through September 30, 2014.

**Tobacco Buyout (Act §§601-643)**

No I.R.C. section; Act §§601-643
Effective on October 22, 2004

**New Law**

The Act repeals all aspects of the federal tobacco support program, including marketing quotas and nonrecourse marketing loans for 2005 and subsequent crops. Eligible quota holders will receive a total of $7 per pound on their basic quota allotment paid in equal installments over 10 years, and eligible producers will receive transition payments of $3 per pound based on their effective quota paid in equal installments over 10 years. No Internal Revenue Code section was changed, and the tax treatment of the payments is not specified in the act. Manufacturers and importers of tobacco products will pay a quarterly assessment on cigarettes, snuff, chewing tobacco, pipe tobacco, roll-your-own tobacco, and cigars during fiscal years 2005 through 2014 into a newly formed Tobacco Trust Fund. The fund will be used to pay quota holders and eligible producers, as well as to pay for program losses incurred by the U.S. Department of Agriculture.

**Expensing for Small Businesses**

I.R.C. §179; Act §201
Effective for tax years beginning after December 31, 2005

**New Law**

The 2004 Jobs Act extends the increased amount that a taxpayer may deduct, and other changes that were made by JGTRRA of 2002, for an additional 2 years.

1. The maximum dollar amount that may be deducted under I.R.C. §179 is $100,000 (adjusted for inflation) for property placed in service in taxable years beginning before 2008 ($25,000 for taxable years beginning in 2008 and thereafter).
2. The $400,000 (adjusted for inflation) investment limit applies for property placed in service in taxable years beginning before 2008 ($200,000 for taxable years beginning in 2008 and thereafter).
3. Off-the-shelf computer software placed in service in taxable years beginning before 2008 is qualifying property.
4. Taxpayers can revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning before 2008.

**Electronic Filing of Excise Tax Reports (Act §864)**

Any person who must report under the ExSTAR systems and who has 25 or more reportable transactions in a month to report in electronic format, effective on January 1, 2006.
Foreign Tax Credit
Recharacterization of Loss
I.R.C. §904; Act §402
Effective for years beginning after December 31, 2006

Background
If a taxpayer's losses from foreign sources exceed its foreign-source income, the excess loss (overall foreign loss) may offset U.S.-source income. Such an offset reduces the effective rate of U.S. tax on U.S.-source income. To eliminate a double benefit (the reduction of U.S. tax and a later allowance of a foreign tax credit), a recapture rule recharacterizes a portion of foreign-source taxable income earned after an overall foreign loss year as U.S.-source taxable income for foreign tax credit purposes.

New Law
The Jobs Act of 2004 provides a similar re-sourcing rule for U.S.-source income when a taxpayer's foreign tax credit limitation was reduced as a result of an overall domestic loss that offset foreign-source taxable income for the year. A portion of the taxpayer's U.S.-source income for each succeeding taxable year will be recharacterized as foreign-source taxable income earned after an overall foreign loss year as U.S.-source taxable income for foreign tax credit purposes.

Reduction of Foreign Tax Credit Baskets
I.R.C. §094; Act §404
For tax years beginning after December 31, 2006

Background
The foreign tax credit is limited to the U.S. tax liability on a taxpayer's foreign-source income to ensure that the credit serves its purpose of mitigating double taxation of cross-border income without offsetting the U.S. tax on U.S.-source income. The limitation is applied separately to nine categories of income.

New Law
The Jobs Act of 2004 reduced the number of separate limitation baskets for the foreign tax credit to two: passive category income and general category income. Creditable foreign taxes that are imposed on amounts that are not income under U.S. tax principles will be treated as imposed on general limitation Income beginning in 2007. A taxpayer may elect to treat base difference items arising in taxable years beginning after 2004 but before 2007 as imposed on either general limitation income or financial services income. The election applies to both the 2005 and 2006 tax years and is revocable only with consent.

Interest Expense Allocation
I.R.C. §864; Act §401
For taxable years beginning after December 31, 2008

Background
To compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Deductions must be allocated and apportioned between items of U.S.-source gross income and items of foreign-source gross income. For interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer. All members of an affiliated group of corporations generally are treated as a single corporation, and allocation must be made on the basis of assets rather than gross income. Affiliated groups do not include foreign corporations.

New Law
The Jobs Act of 2004 provides that the common parent of a domestic affiliated group that is part of a worldwide affiliated group can make a one-time election under I.R.C. §864 to determine the group’s taxable income from sources outside the United States by allocating and apportioning interest expense on a worldwide-group basis. The formula uses a ratio of foreign assets to total assets.
Excise Taxes

Use Tax on Heavy Highway Vehicles

I.R.C. §§4481, 4483, 6156; Act §867
Effective for taxable periods beginning after October 22, 2004

Background

An annual use tax (Form 2290) is imposed on highway vehicles with a taxable gross weight of at least 55,000 pounds. For trucks with a taxable gross weight of 55,000 to 75,000 pounds, the tax is $100 plus $22 per 1,000 pounds over 55,000. The tax is capped at $550 for vehicles over 75,000 pounds. The annual use tax is imposed for a taxable period of July 1 through June 30. In certain cases, taxpayers are allowed to pay the tax in installments. State governments are required to receive proof of payment of the use tax as a condition of vehicle registration. Exemptions and reduced rates are provided for certain “transit-type buses,” trucks used for fewer than 5,000 miles on public highways (7,500 miles for agricultural vehicles), and logging trucks. Any highway motor vehicle that is issued a base plate by Canada or Mexico and is operated on U.S. highways is subject to the highway use tax whether or not the vehicles are required to be registered in the United States. The tax rate for Canadian and Mexican vehicles is 75% of the rate that would otherwise be imposed.

New Law

The Jobs Act of 2004 eliminates both the ability to pay the tax in installments and the reduced rates for Canadian and Mexican vehicles. Taxpayers with 25 or more vehicles for any taxable period are required to file their returns electronically. Proration of tax will be permitted for vehicles sold during the taxable period, as it is for vehicles that are destroyed or stolen.

Example 16. Elimination of Installment Payments

Peter Bilt is an owner-operator who licenses his rig for 80,000 pounds. He has been filing Form 2290 each year in August and paying $137.50 in August, December, March and June, for a total tax of $550. When he files in August 2005, he must pay the entire $550 in a lump sum.

Other Excise Tax Provisions

Numerous other excise tax provisions are included in the Jobs Act of 2004, but they are not covered individually in this update. The excise tax topics and the act sections affecting them are:

- Motor fuel tax for trains and inland waterway commercial transportation (Act §241)
- Suspension of beverage occupational tax (Act §246)
- Bows and arrows (Act §332)
- Fishing tackle boxes and sonar devices (Act §§333, 334)
- Mobile machinery vehicles (Act §851, 852)
- Aviation-grade kerosene (Act §853)
- Mechanical dye injection (Act §§854, 855, 856)
- Dyed diesel fuel use in buses (Act §857)
- On-site inspection of records (Act §858)
- Penalty for refusal of entry (Act §859)
- Registration of pipeline or vessel operators (Act §860)
- Display of registration (Act §861)
- Registration within foreign trade zones (Act §862)
- Penalties for failure to report (Act §863)
- Electronic filing of excise tax reports (Act §864)
- Refunds for ultimate vendors (Act §865)
- Two party fuel holder exchanges (Act §866)
- Dedication of penalties to Highway Trust Fund (Act §868)
- Simplification of tax on tires (Act §869)
- Transmix and diesel fuel blend stocks (Act §870)
- Vaccines for Hepatitis A and influenza (Act §§889, 890)