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The American Jobs Creation Act of 2004

On October 11, 2004, the Senate passed the conference agreement on the American Jobs Creation Act of 2004 (H.R. 4520). The House of Representatives previously passed the measure on October 7, 2004. President Bush has indicated that he will sign the bill into law.

The following is a brief summary of certain significant income tax provisions in the bill.

A. Extraterritorial Income Exclusion Repeal

The bill repeals the controversial foreign sales company/extraterritorial income regime (FSC/ETI) that has been held illegal by the World Trade Organization and led to the imposition of trade sanctions by the European Union. The FSC/ETI repeal is phased-in over the next three years, permitting taxpayers to claim 80% of the ETI benefits for transactions occurring in 2005, 60% for transactions occurring in 2006 and zero percent thereafter. Foreign corporations that have elected to be taxed as a domestic corporation to claim the benefits of the FSC/ETI regime are permitted to revoke such elections within one year of the bill's effective date.

B. Deduction for United States Production Activities

The bill provides a deduction for income attributable to United States production activities. Activities that will generate qualifying income for this purpose include domestic manufacturing activities, energy production (but not transmission or distribution) activities, domestic construction activities (including associated architectural and engineering services), agricultural processing and certain sound recording and film activities (although not sexually explicit productions).

The deduction is equal to a specified percentage (phased-in over the next six years and reaching 9% in 2010) of the lesser of a taxpayer's income from qualifying domestic production activities for the taxable year or the taxpayer's taxable income for the year. The deduction is further limited to 50% of the wages paid by the taxpayer to U.S. employees.

C. Repatriation of Earnings Permanently Invested Offshore

The bill enacts, as a temporary economic stimulus, a rule that permits U.S. corporations that are 10% shareholders of a controlled foreign corporation to claim an 85% dividends-received deduction on certain dividends received from such controlled foreign corporation during a single taxable year; this deduction would result in an effective U.S. federal income tax rate of 5.25% (or less) on such amounts. The deduction would apply to cash payments treated as dividends under the Code that involve actual distributions of cash from a foreign subsidiary, but not to most deemed distributions (i.e., income imputed to a U.S. corporation under the anti-deferral provisions of the Code). The 85% dividends-received deduction is subject to certain limitations, including the following: (1) the deduction applies only to dividends in excess of a base-period average computed by reference to the five most recent taxable years of the U.S. corporation, (2) the total amount of dividends eligible for the deduction may not exceed the greater of the amount of earnings shown as permanently invested outside the United States on the taxpayer's financial statements or $500 million, and (3) in order to qualify for the deduction, the dividends must be subject to a domestic reinvestment plan approved by the U.S. corporation's senior management and board of directors. The repatriation provision is applicable only to dividends received either, at the taxpayer's election, (i) during the U.S. corporation's first taxable year beginning on or after the date of enactment of the bill, or (ii) during the U.S. corporation's last taxable year beginning before such date.

D. Inversions

The bill enacts a series of proposals to combat transactions known as "corporate inversions," in which U.S. corporate groups reorganize as foreign corporations. Under the bill, if a foreign corporation acquires substantially all of the assets of a U.S. corporation in a transaction in which at least 80 % of the stock (by vote or value) of the foreign corporation is owned by former shareholders of the U.S. corporation, the foreign corporation will be treated as if it were itself a U.S. corporation and thus subject to full U.S. tax. For this purpose, stock held by certain related parties and stock issued in a related public offering are disregarded. The provision will not apply if the corporate group has substantial operations in the country of incorporation of its new parent. If the percentage of stock owned by former shareholders of the U.S corporation is less than 80 %, but is 60 % or more, the acquiring foreign corporation will be respected as a foreign corporation, but the "inversion gain," which includes corporate level gains on the inversion transaction itself and certain other income within the following ten years, will be subject to U.S. tax that cannot be sheltered by tax attributes such as NOLs or foreign tax credits. Similar rules apply to U.S. partnerships and their partners if substantially all of the assets constituting a trade or business are acquired by a foreign corporation. In addition, the bill imposes a 15% excise tax on the value of certain stock-related compensation instruments held by directors, officers and insiders at the time of certain inversion transactions. All of the foregoing provisions are drafted quite broadly, and should be examined carefully in the context of any transaction to which they may apply. Finally, the bill broadens the IRS's authority to challenge certain reinsurance arrangements, and adds new information reporting requirements. Unlike certain prior versions of this legislation, the bill is not limited to public companies. The new rules are generally effective for acquisitions completed after March 4, 2003 unless more than half of the relevant assets were acquired on or before that date.

E. Tax Shelter Provisions

A significant number of the highly-publicized tax shelter reform proposals, such as the proposed codification of the economic substance doctrine, are not included in the bill. Nevertheless, the bill contains new penalties and information reporting provisions targeted at so-called "reportable" (identified by Treasury as potentially abusive) and "listed" (specifically identified by Treasury as abusive) transactions. In addition, the bill enacts new provisions specifically tailored to combat certain high profile tax-motivated transactions that Congress deemed abusive. The act targets sale in, lease out transactions (SILOs), repeals the rules relating to financial asset securitization investment trusts (FASITs) and adopts other provisions to respond to specific transactions publicized in the Joint Committee on Taxation's review of Enron transactions or recent tax-shelter cases.

The bill imposes substantial new penalties on organizers and participants in listed and reportable transactions. The bill creates a penalty for any person who fails to include with any return or statement any required information with respect to a reportable or listed transaction. If the taxpayer is an individual, the penalty is $10,000 in the case of a reportable transaction and $100,000 in the case of a listed transaction. For all other taxpayers, the penalties are $50,000 and $200,000, respectively. In addition, the existing accuracy-related penalty is enhanced by imposing a more substantial penalty for certain listed and reportable transactions. Public companies must disclose the imposition of certain of these penalties in Securities and Exchange Commission filings.

Many of the other changes relate to new information reporting and list maintenance requirements for "material advisors" (broadly defined) with respect to any reportable or listed transaction in lieu of the existing tax shelter registration regime and substantial penalties related to such obligations for failure to file or falsely or incompletely filing the required information statement.

The bill also enhances the ability of the IRS to respond to abusive transactions by extending the statute of limitations for assessment in cases where the taxpayer fails to make a required disclosure of its participation in any listed transaction until one year following the date that such information is furnished and expanding the IRS's power to obtain injunctive relief.

F. Nonqualified Deferred Compensation Plans

The bill radically changes the rules for nonqualified deferred compensation plans (including employment contracts and other one-off arrangements). In order to avoid taxation in the year of the deferral (or at the time the deferred compensation vests, if later) rather than in the year of actual payment, the plan must follow several new requirements. These requirements relate to, among other things, the timing of deferral and redeferral elections, the timing of permitted payouts and limiting access to deferred funds while employed. If a deferral does not follow the new rules, a 20% penalty tax is charged in the year the deferral becomes taxable, in addition to regular income tax. Also, if an otherwise effective deferral becomes taxable after the year in which it was made because of a failure to follow the new rules, interest is charged from the date the deferral would have been includable in income (or the date when vested, if later). The bill applies to both elective and nonelective deferred compensation, and can also apply to some arrangements maintained by tax-exempt organizations.

The bill also includes a general prohibition on the use of offshore trusts to hold assets aside for deferred compensation plans, and a ban on features commonly used in the marketplace, such as automatic payout of deferred compensation if an employer's financial health deteriorates, or payout of deferred compensation on demand if a financial penalty is imposed on the amount deferred. By its terms, the bill applies to deferred compensation arrangements for both employees and non-employees (such as independent contractors or outside directors).

In combination, the new rules will make deferred compensation arrangements far less flexible. The bill provides for the IRS to issue guidance excusing certain kinds of plans from compliance. For example, it appears that garden-variety stock options having a fair market value exercise price will not be subject to the new rules, but the rules may apply to stock appreciation rights and phantom stock plans. There are many aspects of the bill that are unclear or ambiguous. Congress has instructed the IRS to issue transition guidance regarding existing arrangements within sixty days following enactment of the bill.

The bill generally does not apply to deferrals before 2005 (including investment gains on old deferrals), but post-2004 deferrals under pre-2005 contracts may not be respected for tax purposes. Clients are strongly cautioned about amending existing arrangements in respect of pre-2005 deferrals, even before the January 1, 2005 effective date, because an existing arrangement which is materially modified after October 3, 2004 will lose grandfathering treatment.

G. Spin-Offs

Under current law, corporations engaging in tax-free spin-offs are permitted to receive property other than stock or securities of the spun-off corporation tax free in connection with forming the spun-off corporation, so long as that property is distributed to creditors as part of the spin-off. Under the bill, the receipt of such property will be tax free only to the extent of the basis of the property transferred to the spun-off corporation. The most significant implication of this change is to make it more difficult to do so-called "debt swaps," in which the parent corporation would receive debt of the spun-off corporation (or cash attributable to new borrowings of the spun-off corporation) which would then be distributed in exchange for (or in repayment of) outstanding debt of the parent corporation. Such debt or cash will now trigger gain recognition in connection with formation of the spun-off corporation if it exceeds the basis of the assets transferred to the newly organized corporation. It appears, however, that it will still be possible to do “debt swaps” in excess of the basis of the assets transferred where the newly issued debt constitutes a security for tax purposes.

H. Partnership Cancellation of Indebtedness

The bill applies the repeal of the “stock for debt exception” for corporations, codified in existing I.R.C. § 108(e)(8), to partnerships. The bill provides that when a partnership transfers a partnership interest to a creditor in satisfaction of partnership debt, the partnership recognizes 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.

I. Interests in Partnerships with Built-in Losses

The bill limits the ability to transfer losses among partners and provides special rules for transfers of interests in certain investment partnerships. In general, the bill provides that built-in losses in contributed property may be taken into account only by the contributing partner. It makes the I.R.C. § 734(b) adjustment mandatory with respect to distributions for which there would be a substantial (more than $250,000) downward basis reduction if an I.R.C. § 754 election were in effect and makes the I.R.C. § 743(b) basis adjustment mandatory if substantial (more than $250,000) built-in losses exist. Special rules apply to “electing investment partnerships” (EIPs) with built-in loss property. In general, an EIP would not be required to adjust the bases of partnership assets following a transfer of a partnership interest, but the ability of the transferee partner to take advantage of its distributive share of losses would be limited. In general, the conferees intended that most private equity funds be eligible for treatment as an EIP. Some funds, however, may not qualify as an EIP under the technical definition set forth in the legislation.

J. S Corporation Simplification

The bill enacts a significant relaxation of the rules governing eligibility to elect S Corporation status. Among other changes, the bill increases the number of permissible shareholders from seventy-five to one hundred and treats certain common lineal descendants (and their spouses) as one shareholder. In addition, the bill enacts taxpayer favorable changes to certain targeted issues associated with S Corporation operations and alleviates the consequences of inadvertent terminations and invalid elections of qualified subchapter S subsidiaries.

K. REIT Provisions

The bill adopts a number of provisions that the REIT industry has sought for several years. One change benefits non-U.S. investors by extending the exemption from FIRPTA (the Foreign Investment in Real Property Tax Act) for sales of stock in publicly traded REITs by holders of 5% or less of the REIT’s stock to cover distributions to such shareholders of the proceeds of underlying real estate sales. The principal effect of the remaining changes is to make it easier for corporations to meet the stringent technical requirements for REIT qualification, or to ameliorate the impact of failure to satisfy those requirements. First, there are rules permitting REITs to avoid automatic disqualification if they fail to satisfy the requirements that the securities of one issuer not represent more than 5% of the assets of a REIT and that a REIT not hold more than 10% in vote or value of the securities of one issuer (apart from real estate assets, such as REIT stock or mortgages). In each case, so long as the violation is due to reasonable cause and not willful neglect and is corrected within six months of the end of the quarter in which it is discovered, it will not result in disqualification. Except in the case of certain de minimis violations, a modest penalty tax must be paid as well. Second, there is an expansion of the "straight debt" exception to the 10% rule, including a provision permitting the timing of interest payments to be contingent on cash flow, and permitting non-mortgage securities issued by another REIT to qualify for the exception.

L. Foreign Tax Credit Provisions

The bill simplifies and liberalizes certain rules applicable to foreign tax credits. The effective dates on these provisions are generally deferred. First, the bill would generally reduce (applicable for taxable years beginning after 2006) the number of foreign tax credit limitation categories from nine under existing law to two, the passive category income and general category income. Second, the bill modifies the rules for calculating the foreign tax credit limitation. It allows taxpayers, for purposes of allocating interest expense between U.S. and foreign sources, a favorable one-time election (applicable for taxable years beginning after 2008) that, for affected taxpayers, will result increased availability of foreign tax credits. The bill also adopts overall domestic loss recapture rules (applicable for taxable years beginning after 2006) by re-sourcing U.S source income in cases in which a taxpayer's foreign tax credit limitation has been reduced as a result of an overall domestic loss in a previous taxable year. Finally, the bill changes the existing two-year carryback and five-year carryforward for excess foreign tax credits to one year and ten years, respectively (for taxable years ending after the date of the bill's enactment).

M. Temporary Repeal of Withholding Tax on Certain RIC Dividends

The bill provides a temporary rule (generally from 2005 through 2007) that a regulated investment company (RIC) that earns certain income that would not be subject to U.S. tax if earned directly by a foreign person is permitted, to the extent of such income, to designate a dividend that it pays as derived from such income. A foreign person who is a shareholder in the RIC generally would treat such a designated dividend as exempt from U.S. withholding tax.

N. Repeal of Foreign Personal Holding Company Rules

The bill eliminates the foreign personal holding company and foreign investment company regimes and excludes foreign corporations from the application of the personal holding company rules.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Tax Department, including:

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