SIMPSON THACHER

AMERICAN JOBS CREATION ACT OF 2004

OCTOBER 26, 2004

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AMERICAN JOBS CREATION ACT OF 2004

OCTOBER 26, 2004

On October 22, 2004, President Bush signed The American Jobs Creation Act of 2004 (the "Act"). This memorandum briefly describes some of the important provisions of the Act.

REPEAL OF EXCLUSION FOR EXTRATERRITORIAL INCOME AND DEDUCTIONS FOR DOMESTIC PRODUCTION ACTIVITIES

The Act repeals the extraterritorial income ("ETI") exclusion, which provided an exclusion from gross income with respect to certain exporting activities, that was declared a prohibited export subsidy by the World Trade Organization in 2000. Sections 114 and 941 through 943 of the Internal Revenue Code of 1986, as amended (the "Code")[1] have been amended accordingly. The ETI exclusion has been replaced with tax relief incentives for United States based manufacturing activities. The repeal is effective for transactions after December 31, 2004; however, certain transitional rules apply until 2006 as well as for certain transactions that are pursuant to a binding contract in effect on September 17, 2003 and thereafter.

The Act adds Section 199 of the Code to provide a deduction against income for domestic production activities. Domestic production activities include (i) the sale, lease or license of property that was manufactured or produced by the taxpayer in whole or in significant part within the United States; (ii) the sale, lease or license of certain United States produced motion pictures and videotapes; (iii) the sale of electricity, natural gas or potable water produced by the taxpayer in the United States; (iv) construction activities performed in the United States; and (v) engineering or architectural services performed in the United States for construction projects located in the United States. For taxable years beginning after 2009, the deduction is equal to nine percent of the lesser of (i) the domestic production activities income of the taxpayer for the taxable year, or (ii) taxable income (determined without regard to new Section 199) for the taxable year. The deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during the calendar year that ends in such taxable year. The deduction will be phased in for taxable years 2005 and 2006 at a rate of three percent, and will increase to six percent for taxable years 2007 through 2009.

1 All section references, unless otherwise indicated, are to the sections of the Code.

When fully phased in, the deduction could reduce a corporation's effective tax rate to 31.85 percent. With respect to domestic production activities of a passthrough entity, the deduction is generally determined at the shareholder, partner or similar level by taking into account at such level the proportionate share of income attributable to domestic production activities. The deduction for domestic production activities is allowed for purposes of computing a taxpayer's alternative minimum taxable income.

TAX SHELTERS

As a result of concerns regarding the proliferation of tax shelters, the Internal Revenue Service (the "IRS") has sought additional tools to deal with such tax shelters more effectively. The Act provides those tools by way of additional reporting and disclosure requirements and the imposition of substantial penalties on taxpayers and tax shelter advisors. The Act also addresses certain procedural and other miscellaneous issues, including the attorney-client privilege, statute of limitations periods for assessments of taxes and disallowance of the deduction for interest on a tax deficiency in certain circumstances. The principal elements of the Act with respect to tax shelters include:

- Replacement of the tax shelter registration requirement for promoters with requirements for material advisors to file information returns with respect to reportable transactions;
- Imposition of significant penalties on taxpayers and material advisors for failing to file the required disclosure information regarding reportable transactions;
- Substantial increase in the penalties imposed on material advisors for failing to maintain investor lists; and
- Tightening of procedural requirements with respect to tax shelters, including the exception to the attorney-client privilege between a federally authorized tax practitioner and the taxpayer, an extension of the statute of limitations for assessments of taxes with respect to listed transactions and the disallowance of an interest deduction for interest paid or accrued on an underpayment of tax attributable to an undisclosed reportable transaction.

Information Returns and List Maintenance Requirements

Information Returns. Under the Act, the current rules requiring the registration of tax shelters are repealed. Instead, each material advisor with respect to a reportable transaction is required to file an information return including information identifying and describing the transaction and information describing any potential tax benefits expected to result from the transaction. For these purposes, a "material advisor" is any person (i) who provides material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, insuring or carrying out any reportable transaction and (ii) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction from which substantially all of the tax benefits are provided to natural persons) for such advice or assistance. A "reportable transaction" is one of the six enumerated transactions described in Treas. Reg. § 1.6011-4(b) (listed transactions, confidential transactions, transactions with contractual protection, transactions with significant book-tax difference and transactions involving a brief asset holding period).

List Maintenance. The Act also modifies the list maintenance requirements so that with respect to a reportable transaction, each material advisor must maintain a list identifying each person for whom the advisor acted as a material advisor for such transaction (along with any other information as may be required under U.S. Treasury regulations).

Penalties

Tax Shelter Advisors. The Act imposes significant penalties on material advisors who fail to file the information returns discussed above or who file false or incomplete information returns with respect to reportable transactions. Under the new legislation, each failure to file or false or incomplete filing will be subject to a penalty of $50,000, except in the case of a listed transaction, in which case the penalty will be an amount equal to the greater of (i) $200,000 or (ii) 50 percent of the gross income derived by the material advisor with respect to aid, assistance or advice provided with respect to the listed transaction before the date the information return is filed (or 75 percent of such amount in the case of an intentional failure to file the required information return).

Additionally, the current penalty of $50 for failing to provide an investor list upon written request (with a maximum penalty of $100,000) has been increased to $10,000 for each day after the date upon which the investor list was to be provided. No penalty will be imposed, however, if the failure to make the list available is due to reasonable cause.

The Act also significantly increases the penalty imposed on a person that organizes or participates in the sale of any interest in a tax shelter who also makes a statement regarding the availability of tax benefits which the person knows or has reason to know is false or fraudulent. The former penalty of the lesser of $1000 or 100 percent of the gross income derived or to be derived by the person from the tax shelter has been increased to a penalty of 50 percent of the gross income derived by the person from the activity for which the penalty is imposed.

Taxpayers. Currently, taxpayers do not suffer any direct penalties for failing to disclose a reportable transaction. However, under the Act, penalties will be imposed on taxpayers who fail to include on any return or statement information with respect to a reportable transaction. The amount of the penalties shall be $10,000 for a natural person and $50,000 in any other case, unless the transaction is a listed transaction, in which case the penalties shall be $100,000 for a natural person and $200,000 in any other case.

The Act also adds accuracy-related penalties applicable to listed transactions and reportable transactions with a significant tax avoidance purpose. Generally, a 20 percent accuracy-related penalty will be imposed on any understatement attributable to an adequately disclosed listed transaction or tax avoidance reportable transaction. The penalty will be increased to 30 percent for an understatement attributable to an undisclosed transaction. The 20 percent penalty will not be imposed if the taxpayer shows that there was reasonable cause for the understatement and that the taxpayer acted in good faith. In order to establish such reasonable cause and good faith, (i) the taxpayer must adequately disclose the transaction, (ii) there must be substantial authority for the taxpayer's treatment of the transaction and (iii) the taxpayer must reasonably believe that such treatment was more likely than not the proper treatment.

Miscellaneous Provisions

The Act includes a number of other miscellaneous provisions related to tax shelters, including (i) expansion of the exception to the attorney-client privilege for written communications between any taxpayer and any federally authorized tax practitioner, (ii) extension of the statute of limitations period for assessment of taxes with respect to listed transactions if a taxpayer fails to attach the requisite information to its tax return, (iii) disallowance of any deduction for interest paid or accrued on any underpayment of tax attributable to a reportable transaction if the relevant facts affecting the tax treatment of the item are not adequately disclosed and (iv) authorization of civil action to enjoin a material advisor from (a) failing to file an information return with respect to a reportable transaction, (b) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction or (c) violating any of the rules under Circular 230, which regulates the practice of representatives of persons before the Department of the Treasury.

Effective Dates

The tax shelter provisions are effective after the date of the enactment of the Act. In some cases, the provisions will apply to transactions entered into prior to enactment based on circumstances and activities occurring after the enactment date. For example, material advisors will be subject to penalties for failing to maintain and provide a list to the Secretary for a transaction that was entered into prior to the date of enactment as long as the written request for the list is made after the date of enactment. Additionally, taxpayers that are participants in reportable transactions will be required to pay significant penalties if they fail to file the required information on such transactions with their tax returns.

CORPORATE EXPATRIATION

Expatriated Entities and their Foreign Parent Corporations

The Act adds Section 7874 to impose adverse tax consequences on certain United States corporations and partnerships that reincorporate in a foreign jurisdiction (an “inversion transaction”). Section 7874 defines two different types of inversion transactions and establishes different tax consequences for each type. First, where (i) a U.S. entity becomes a subsidiary of a foreign-incorporated entity, (ii) the former shareholders of the U.S. entity hold 80 percent or more of the stock of the foreign-incorporated entity after the transaction and (iii) the foreign-incorporated entity does not have substantial business activities in its country of incorporation, Section 7874 deems the top-tier foreign corporation to be a domestic corporation for all purposes of the Code (a "Full Inversion"). Second, where a transaction would otherwise meet the definition of a Full Inversion, except that a 60 percent ownership threshold, but not an 80 percent threshold is met, Section 7874 generally provides that any corporate-level "toll charges" for establishing the inverted structure may not be offset by tax attributes such as net operating losses or foreign tax credits (a "Partial Inversion"). These provisions apply to taxable years ending after March 4, 2003. Section 7874 does not apply to an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity has already acquired more than half of the properties held by the domestic entity.

Stock Compensation of Insiders in Expatriated Corporations

The Act adds Section 4985 to impose an excise tax on specified holders of stock options and other stock-based compensation upon certain inversion transactions. Such holders generally include officers, directors and 10 percent owners of private and publicly held corporations. The excise tax is imposed at a rate of 15 percent for 2005 through 2008 and 20 percent for taxable years beginning 2009, and applies only to stock compensation during the twelve-month period beginning six months before the inversion transaction. The excise tax is imposed on such holders only if gain is recognized in whole or in part by any shareholder by reason of the inversion transaction. Inversion transactions for this purpose are defined by new Section 7874, discussed above, and include both Full and Partial Inversions. Holders of stock compensation are also taxed on any payments received from the U.S. expatriated entity that are intended to be reimbursement for the excise tax, and the U.S. expatriated entity is denied a deduction for any such payment.

INCENTIVES TO REINVEST FOREIGN EARNINGS IN THE UNITED STATES

The Act adds Section 965, which provides an election under which a U.S. corporate shareholder may deduct 85 percent of certain cash dividends received from a controlled foreign corporation ("CFC") in which it is a "U.S. shareholder." This one time deduction is intended to encourage repatriation of foreign earnings and provide economic stimulus to the U.S. economy.

The election may only be made for either the taxpayer's last taxable year beginning before the date of enactment or the first taxable year that begins during the 1-year period beginning on the date of enactment. Only "cash" dividends that exceed average repatriated earnings over three of the five most recent taxable years ending on June 30, 2003 are eligible for the deduction.[2] The Conference Report indicates that cash dividends include cash amounts

[2] Amounts counted as repatriated earnings include dividends received from CFCs, income inclusions with respect to investments in U.S. property (as defined under Section 956) and distributions of previously taxed income.

treated as dividends under Section 302 or Section 304 (but not amounts treated as dividends under Sections 78, 367 or 1248). Subpart F inclusions or inclusions under Section 956 are not treated as cash dividends for these purposes.[3] The amount of deductible dividends cannot exceed the greater of:

- $500,000,000, or
- the amount reported as earnings permanently invested outside the U.S. on the taxpayer's audited financial statement filed with the SEC on or before June 30, 2003, or if the audited financial statement is not filed with the SEC filed, an audited financial statement certified on or before June 30, 2003 and used as a statement or report to shareholders, creditors or for any other substantive non-tax purpose, or
- if the applicable financial statement does not specify earnings permanently invested outside the U.S. but shows a specific amount of tax resulting from such earnings, the amount equal to such tax liability divided by .35.

Dividends are not eligible for deduction to the extent a CFC increases debt from certain related parties (other than another CFC) during the period from October 3, 2004 until the end of the taxable year for which the election is made. This rule is intended to prevent a taxpayer from claiming a deduction in cases in which the taxpayer itself directly or indirectly finances the payment of a dividend from a CFC.

The taxpayer must invest the dividends pursuant to a domestic reinvestment plan that is approved by both senior management (e.g., the chief executive officer or comparable official) and the board of directors (or similar group). The domestic reinvestment plan must provide for investment of the funds in the United States, such as in capital investments, workforce expansion and training, R&D or financial stabilization of the corporation for the purpose of job retention or creation. The list of permitted uses is not exclusive, and the conference report indicates that the concept is to be construed broadly. However, repatriated funds may not be used to pay for executive compensation.

Tax credits and deductions may not be used to reduce any tax liability with respect to a dividend that is deductible under this provision.

[3] Cash dividends of previously taxed income are not deductible, except to the extent the distribution results in the inclusion of Subpart F income due to the payment of the dividend from one CFC to another controlled corporation within a chain of ownership, and the cash payment ultimately flows to the taxpayer in the year the election is effective.

INTERNATIONAL PROVISIONS

The Act contains a number of provisions that modify the taxation of U.S. taxpayers with international operations.

Foreign Tax Credits

Interest Expense Allocation Rules. For purposes of calculating the foreign tax credit limitation, Section 864 has been amended to provide a one-time election to change the method of allocating the interest expense of U.S. members of an affiliated group between U.S. source and foreign source income. Upon making the election, the worldwide affiliated group will calculate the foreign source taxable income of domestic members by allocating and apportioning the third party interest expense of such domestic members to foreign source income in an amount equal to the excess (if any) of:

- the worldwide affiliated group's worldwide third party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group, over
- the third party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.

For purposes of the election, a "worldwide affiliated group" means all members of an "affiliated group" as defined under present law for interest allocation purposes, as well as all CFCs that, directly or indirectly, would be members of the affiliated group if foreign corporations were not excluded from the definition of affiliated group. The provision allows taxpayers to elect to exclude certain financial institutions from the worldwide affiliated group for interest allocation purposes. This provision is effective for taxable years beginning after December 31, 2008.

Recharacterization of Overall Domestic Loss. Under current law, a taxpayer's foreign source income earned in a year subsequent to a year in which the taxpayer generates an overall foreign source loss is, subject to limitations, characterized as U.S. source income for purposes of calculating foreign tax credit limitations. No equivalent rule applies in respect of an overall domestic loss that reduces a taxpayer's foreign source income (and thus its ability to credit foreign taxes). The Act amends Section 904 to provide a re-sourcing rule to mitigate the impact of a lower foreign tax credit limitation caused by an overall domestic loss. Subsequent to a taxable year in which a taxpayer incurs an overall domestic loss, U.S. source income is recharacterized as foreign source income in an amount equal to the lesser of:

- the amount of the unrecharacterized overall domestic losses for years prior to such succeeding taxable year, and
- 50 percent of the taxpayer's U.S. source income for such succeeding taxable year.

Under the provision, an "overall domestic loss" is defined as any domestic loss to the extent it offsets foreign source income in the current taxable year or any preceding taxable year by reason of a loss carryback. An overall domestic loss does not include a loss in a year for which the taxpayer did not elect to use the foreign tax credit. Income recharacterized as foreign source is allocated among the foreign tax credit limitation baskets in the same manner that the baskets were reduced by the earlier overall domestic loss. This provision is effective for losses incurred in taxable years beginning after December 31, 2006.

Look-Through Rules to Apply to Dividends from Noncontrolled Section 902 Corporations. The Act amends Section 904 to apply a look-through analysis to dividends received by a taxpayer from a noncontrolled Section 902 corporation regardless of when the related earnings were accumulated for purposes of allocating the dividend income among the foreign tax credit limitation baskets. Under the look through approach, dividends paid by a noncontrolled Section 902 corporation are allocated to each foreign tax credit limitation basket in the same proportion that the corporation's earnings and profits attributable to income in such basket bears to the corporation's total earnings and profits. A "noncontrolled Section 902 corporation" is a foreign corporation, which is not a CFC, in which the taxpayer owns at least 10 percent of the voting stock.

The Secretary is authorized to treat a dividend from a noncontrolled Section 902 corporation as passive basket income if the taxpayer fails to adequately substantiate the assignment of the dividend to the proper foreign tax credit limitation basket. This provision is effective for taxable years beginning after December 31, 2002. Transitional rules are provided for the use of applicable pre-effective date foreign tax credits in post-effective date years.

Reduction of Foreign Tax Credit Baskets. The Act amends Section 904 to reduce the number of foreign tax credit limitation baskets from nine to two: a passive income basket and a general income basket. Income meeting the applicable definition of financial services income that is earned by any person predominantly engaged in the active conduct of a banking, insurance, financing or other similar business is assigned to the general income basket. Additionally, items of income that are taxable under foreign tax principles but not under U.S. tax principles ("base income items") fall into the general income basket. Otherwise, subject to certain specified exceptions, income is included in either the passive income basket or general income basket as appropriate.

The provision generally is effective for taxable years beginning after December 31, 2006. Taxes that are carried forward to taxable years beginning after December 31, 2006 are treated as if this provision was in effect when such taxes were paid or accrued. The portions of the provision dealing with base income items are effective for taxable years beginning after December 31, 2004.

Attribution of Stock Ownership Through Partnerships to Apply in Determining Section 902 and Section 960 Credits. The Act amends Section 902 to clarify that stock indirectly owned through a partnership is considered proportionately owned by its partners for purposes of Section 902. In general, Section 902 provides that a domestic corporation is eligible to claim a deemed paid foreign tax credit for taxes paid by a foreign corporation if it owns at least 10 percent of the voting stock of the foreign corporation. The Act also amends Section 901 to clarify that corporate partners or beneficiaries, in addition to individuals, may claim direct foreign tax credits with respect to their allocable share of taxes paid or accrued by a partnership, estate or trust. This provision is applicable to taxes in taxable years of foreign corporations beginning after the date of enactment.

Clarification of Treatment of Certain Transfers of Intangible Property. The Act amends Section 367(d) to provide that deemed payments that result from a tax-free transfer of intangible property by a domestic corporation to a foreign corporation are treated as royalty payments for purposes of applying the separate limitation baskets for foreign tax credit purposes. This provision is effective for amounts treated as received on or after August 5, 1997.

Foreign Tax Credit Carryovers and Carrybacks. The Act amends Section 904 to extend the carryforward period for foreign tax credits from 5 years to 10 years and reduce the carryback period for foreign tax credits from 2 years to 1 year. The provision extending the carryforward period to ten years is effective for excess foreign tax credits that can be carried forward to any taxable year ending after the date of enactment, and the provision limiting the carryback period to 1 year is effective for excess foreign tax credits arising in taxable years beginning after the date of enactment.

Foreign Tax Credit Under Alternative Minimum Tax. The Act amends Section 59 to increase, from 90 percent to 100 percent, the amount of alternative minimum tax liability for a taxable year that taxpayers may offset by using alternative minimum tax foreign tax credits. This provision is effective for taxable years beginning after December 31, 2004.

Minimum Holding Period for Foreign Tax Credit on Withholding Taxes On Income Other Than Dividends. The Acts amends Section 901 to impose a minimum holding period for eligibility to claim foreign tax credits for foreign withholding taxes resulting from income and gain other than dividends (a similar rule currently applies in respect of dividends). Foreign tax credits are disallowed for withholding taxes imposed on income or gain with respect to any property that a taxpayer has not held for more than 15 days within the 31-day period beginning 15 days before the date the right to receive payment arises. A taxpayer's holding period is tolled to the extent that the taxpayer is protected from any risk of loss on a transfer of the property. Sales of property by active dealers in such property are excluded from the holding period rule. In addition, the Conference Report indicates that it is expected that Treasury will issue regulations to permit certain hedging activities without triggering credit disallowance. This provision is effective for amounts that are paid or accrued more than 30 days after the date of enactment.

Recapture of Overall Foreign Losses on Sale of CFC Stock. The Act amends Section 904 to expand the application of a special overall foreign loss recapture rule for dispositions by a taxpayer of a foreign trade or business. Under this provision, a disposition of CFC stock by a controlling shareholder results in the recognition of income in an amount equal to the lesser of:

- the fair market value of the stock over its adjusted basis, or

- the amount of prior unrecaptured overall foreign losses.

100 percent of the recognized income is resourced as U.S. source income for foreign tax credit limitation purposes.

The provision generally applies to transfers, whether taxable or tax-free, of CFC stock by an owner of more than 50 percent of the vote or value of such stock. There are exceptions for internal restructurings, such as a contribution of stock to partnerships or corporations in tax-free transactions, provided that the transferor's indirect ownership percentage does not decrease, and acquisitions of assets for stock that otherwise qualify as tax-free liquidations or reorganizations. This provision is effective for dispositions occurring after the date of enactment.

Anti-Deferral Provisions

Look-Through Treatment for Sales of Partnership Interests. The Act amends Section 954 to provide look-through treatment for certain sales of partnership interests by a CFC for purposes of determining the subpart F income of a CFC. Any sale of a partnership interest by a CFC that is a 25-percent owner shall be treated as a sale of a proportionate share of the assets of the partnership attributable to the interest. A "25-percent owner" is a CFC that owns, directly or indirectly, at least 25 percent of the capital or profits interest in a partnership. This provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Repeal of Foreign Personal Holding Company Rules and Foreign Investment Company Rules. The Act repeals the provisions of the Code relating to foreign personal holding companies and foreign investment companies. Additionally, Section 542 is amended to exclude foreign corporations from the application of the personal holding company rules. Section 954 is amended to include income from personal service contracts as foreign personal holding company income. This provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Modification of Exceptions Under Subpart F for Active Financing. The Act amends Section 954 to expand the temporary exception under subpart F for income derived from the active conduct of a banking or financing business by an eligible CFC or qualified business unit. Income will be treated as derived directly by an eligible CFC or qualified business unit, provided that the activity is:

- performed in the home country of the eligible CFC or qualified business unit,
- carried out by employees of a related person, which is itself an eligible CFC with the same home country, and
- compensated at arm's length and treated by the related person as earned in its home country under the home country's tax laws.

This provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Clarification of Banking Business for Purposes of Determining Investment of Earnings in U.S. Property. The Act amends Section 956 to clarify that the exception from the definition of U.S. property for bank deposits only applies to a deposit with a statutorily defined bank or with a corporation that is more than 80 percent owned by a statutorily defined bank or financial holding company. This provision, which in effect overrules the decision reached in The Limited, Inc. v. Comm.,[4] is effective on the date of enactment.

U.S. Property Not to Include Certain Assets of CFCs. The Act amends Section 956 to provide two additional exclusions to the definition of U.S. property for:

- certain securities held by a CFC in the ordinary course of its business as a dealer, and
- obligations acquired by a CFC and issued by a U.S. person that is not (1) a domestic corporation, (2) a United States shareholder of the CFC or (3) a partnership, estate or trust in which the CFC or any related person is a partner, beneficiary or trustee.

This provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Aircraft Leasing and Shipping Income. The Act amends Section 954 to repeal the subpart F rules relating to "foreign base company shipping income" and to create a safe-harbor for rents derived from leasing an aircraft or vessel from characterization as subpart F income. This rule will permit U.S. taxpayers to defer U.S. taxes on qualifying leasing activity and international shipping and transportation activity. This provision is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Miscellaneous International Provisions

Interest Paid by Foreign Partnerships and Foreign Corporations. The Act amends Section 861 to provide that interest paid by a foreign partnership is not U.S. source income if:

- the interest is not paid by a U.S. trade or business of the partnership, and
- the interest is not allocable to income that is effectively connected with a U.S. trade or business.

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

[4] 286 F.3d 324 (6th Cir. 2002).

Effectively Connected Income to Include Certain Foreign Source Income. The Act amends Section 864 to broaden the application of rules that characterize foreign source income as effectively connected with a U.S. trade or business ("ECI"). Foreign source income is treated as ECI if it is economically equivalent to applicable foreign source income treated under prior law as ECI. The provision applies to income that is economically equivalent to foreign-source:

- rents and royalties,
- dividends and interest, and
- income on sales or exchanges of goods in the ordinary course of business.

This provision is effective for taxable years beginning after the date of enactment.

Translation of Foreign Taxes. The Act amends Section 986 to provide an election to allow taxpayers to translate certain foreign income tax payments into U.S. dollar amounts using the exchange rate in effect at the time the taxes are paid. This provision is effective for taxable years beginning after December 31, 2004.

Repeal of Withholding Tax on Dividends from Certain Foreign Corporations. The Act amends Section 871 to repeal the so-called "secondary withholding tax" imposed on dividends paid by certain foreign corporations. This provision is effective for payments made after December 31, 2004.

TAX ACCOUNTING AND FINANCIAL PRODUCTS

The Act contains several amendments to the Code relating to tax accounting and the treatment of financial products. The following summary highlights selected provisions relating to depreciation, interest deductibility, and particular transactions employing financial products.

Modification of Application of Income Forecast Method of Depreciation

The Act amends Section 167(g), which contains rules pertaining to depreciation under the "income forecast method," by adding rules relating to the treatment of participations and residuals under such method. Participations and residuals are defined as "costs the amount of which by contract varies with the amount of income earned in connection with such property." New Section 167(g)(7)(A) provides generally that, for purposes of calculating the allowable deduction for property under the income forecast method, such costs may be added to the adjusted basis of the related property to the extent they relate to income estimated to be earned within 10 years of the taxable year in which the property is first placed in service. In addition, Section 1092(a)(7)(D) has been added to the Code, approving the methodology set forth in Associated Patentees, Inc. v. Commissioner,[5] which permits taxpayers to instead deduct

5 Associated Patentees Inc., 4 T.C. 979 (1945).

participations and residuals in the taxable year in which they are paid. The Act also clarifies that the relevant income taken into account with respect to property for purposes of the income forecast method is the taxpayer's gross income relating to such property. The foregoing amendments apply to property placed in service after the date of enactment of the Act.

Treatment of Stripped Interests in Bond and Preferred Stock Funds, Etc.

Sections 1286 and 305(e) provide special rules relating to the treatment of "stripped bonds" and "stripped preferred stock," defined as debt or preferred stock in which ownership of the related interest coupons or dividends, as the case may be, have been separated prior to becoming due or payable. Upon separation, current law requires an allocation of the overall adjusted basis in the debt or preferred stock to the respective components based on fair market value for purposes of calculating the seller's gain or loss on disposition of either the underlying instrument or its related interest coupons or dividends. Furthermore, each of the components is generally treated as reissued with original issue discount. The Act amends Section 1286 by adding Section 1286(f), authorizing Treasury to promulgate regulations applying the principles of Sections 1286 and 305(e) to "an account or entity substantially all of the assets of which consist of bonds, preferred stock, or a combination thereof" if current law would not otherwise apply. The foregoing amendments apply to purchases and dispositions occurring after the date of enactment of the Act.

Prevention of Mismatching of Interest and Original Issue Discount Deductions and Income Inclusions in Transactions With Related Foreign Persons

Under current law, Section 163(e)(3) generally disallows deductions for original issue discount ("OID") on a debt instrument that is held by a related foreign person until amounts attributable to such OID are paid. The Act amends Section 163(e)(3) to add a special rule relating to debt instruments with OID held by a related foreign person that is either a CFC or a passive foreign investment company. The Act provides an exception to the general rule of Section 163(e)(3) by permitting a deduction in such cases for amounts attributable to OID to the extent such amounts have been included in the income of certain direct or indirect United States shareholders under the applicable anti-deferral regime. The Act also authorizes Treasury to promulgate regulations excluding certain transactions from the application of such rule. The foregoing amendments apply to amounts accrued on or after the date of enactment of the Act.

Expanded Disallowance of Deduction for Interest on Convertible Debt

Under the Act, Section 163(l), which currently disallows deductions on indebtedness that is payable in equity of the issuer or a related party, has been expanded to cover indebtedness payable in equity held by the issuer or any related party in any other person. The Act further provides that the basis of such equity is increased by the amount of any such disallowance. However, the Act provides an exception for indebtedness issued by a dealer in securities or a related party which is payable in equity held by such dealer in its capacity as a dealer in securities. The foregoing amendments apply to debt instruments issued after October 3, 2004.

Modification of Straddle Rules

Section 1092 defines a "straddle" as offsetting positions with respect to personal property. The Act amends Section 1092, which provides rules governing the treatment of "straddles," to provide rules (i) relating to the identification of straddles and the proper treatment thereof, (ii) clarifying the consequences of the physical settlement of straddle positions by the delivery of property to which such positions relate, and (iii) expanding the application of the straddle rules to stock and positions therein. In addition, Section 246(c), containing certain holding period requirements necessary to claim a dividends-received-deduction with respect to stock, has been amended to provide that a taxpayer's holding period for such purposes will be reduced for any period in which the taxpayer holds certain in-the-money call options relating to such stock. Moreover, the Act explicitly grants Treasury the authority to promulgate rules regarding identified straddles, including the proper method of identification, the consequences of a failure to properly identify the positions of an identified straddle, and technical rules relating to the disposition of less than an entire position that is part of an identified straddle. The foregoing amendments apply to positions entered into on or after the date of enactment of the Act.

CORPORATIONS

Limitation on Transfer or Importation of Built-In Losses

The Act amends Section 362 to provide that property with a built-in loss that is imported into the United States in a tax-free transfer under Section 351 or in a reorganization under Section 368 from persons not subject to U.S. income tax shall have its basis reduced to equal its fair market value. The Act also amends Section 334 to provide for similar rules upon a tax-free liquidation by a domestic corporation of its foreign subsidiary.

Additionally, for transfers not covered by the loss importation rule described above, the Act amends Section 362 to provide that, if property with built-in losses is transferred tax-free to a corporation under Section 351, the transferee’s basis in the transferred assets is reduced to equal its fair market value. Amended Section 362 allows the transferor and transferee to elect to limit the basis in the stock received by the transferor instead of reducing the basis in the transferred assets in the hands of the transferee. These provisions are effective for transactions and liquidations after the date of enactment of the Act.

Affirmation of Consolidated Return Regulation Authority

The Act amends Section 1502 to authorize the Treasury Department to issue consolidated return regulations that treat corporations filing consolidated returns differently from corporations filing separate returns. Prior to this amendment, a recent case[6] had

[6] Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001).

suggested that the Treasury lacked this authority. This provision is effective for taxable years beginning before, on or after the date of enactment of the Act.

Prohibition of Nonrecognition of Gain through Complete Liquidation of Holding Company

The Act amends Section 332 to provide that, on the liquidation of a domestic holding corporation (defined as a corporation, substantially all of the assets of which consist of stock in other members of an affiliated group) owned by one or more foreign persons, the distribution in liquidation is treated as a dividend (to the extent of earnings and profits) if the domestic holding corporation was in existence for less than five years. Such a dividend would be subject to withholding at a 30 percent rate, subject to reduction if a treaty applies. Under prior law, any distribution by a domestic corporation to a foreign corporation in complete liquidation would be treated as a sale or exchange of the stock of the domestic corporation and thus, would generally not be subject to taxation in the United States. These provisions are effective for distributions in complete liquidation occurring on or after the date of enactment of the Act.

Treatment of Transfers to Creditors in Divisive Reorganizations

The Act amends Section 361 such that money or other property received in a divisive "D" reorganization (such as a spin-off) and transferred by a distributing corporation to its creditors will be subject to gain recognition to the extent the amount of such money or property exceeds the basis of the assets contributed to the controlled corporation. Previously, no gain was recognized if money or property (i.e., "boot") received by a transferor corporation in a divisive "D" reorganization was transferred to its creditors. In addition, Section 357 has been amended to provide that acquisitive "D" reorganizations are no longer subject to the rule that requires a transferor corporation to recognize gain if the amount of liabilities assumed by the transferee corporation exceeds the total basis of the property transferred. These provisions are effective for transfers of money, other property or liabilities assumed in connection with a reorganization occurring on or after the date of enactment of the Act.

Definition of Non-Qualified Preferred Stock

The Act amends Section 351 to clarify that "nonqualified preferred stock" includes stock for which there is no real or meaningful likelihood of the shareholder actually participating in corporate growth to any significant extent. "Nonqualified preferred stock" received in tax-free corporate transactions is treated as boot, and any gain on the transaction is recognized by the shareholder to the extent of boot received by such shareholder. This provision is effective for transactions after May 14, 2003.

Definition of Controlled Group of Corporations

The Act amends Section 1563 to provide that solely for purposes of determining a corporation's tax bracket under Section 1561, a "brother-sister controlled group" means two or more corporations if five or fewer persons who are individuals, estates or trusts own stock possessing more that 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of all stock, taking into account the stock ownership of each person only to the extent that the stock ownership is identical with respect to each corporation. Under prior law, the ownership test for a "brother-sister controlled group" was (i) at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total value of all stock and (ii) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of all stock, taking into account the stock ownership of each person only to the extent that the stock ownership is identical with respect to each corporation. In all other instances, the definition of "brother-sister controlled group" retains the definition prior to the Act. These provisions are effective taxable years beginning after the date of enactment of the Act.

PARTNERSHIPS

Disallowance of Certain Partnership Loss Transfers

The Act amends Section 704 to provide that if property with a built-in loss is contributed to a partnership, only the contributing partner may take into account such built-in loss. All other partners, including a partner who acquires the partnership interest of the contributing partner, must treat the property contributed as if the basis equals the fair market value of the property at the time of contribution.

The Act amends Section 743 to require a basis adjustment of a partnership's assets to the transferee upon the transfer of a partnership interest with a "substantial built-in loss" (defined as when the partnership's basis in its property exceeds the fair market value of the partnership's property by more than $250,000). Under prior law, such adjustment under Section 743 was solely at the election of the partnership under Section 754. This requirement does not apply to "electing investment partnerships" or "securitization partnerships."

Finally, the Act amends Section 734 to require a basis adjustment upon a distribution of property to a partner for which there is a "substantial basis reduction" (defined as a downward adjustment of the basis of partnership assets of greater than $250,000 if the partnership made an election to decrease the basis of its assets to reflect the decrease in the adjusted basis of the distributed assets in the hands of the distributee partner). Under prior law, such adjustment under Section 734 was solely at the election of the partnership under Section 754. This requirement does not apply to "securitization partnerships." These provisions are effective for contributions, transfers and distributions after the date of enactment of the Act.

No Reduction of Basis in Stock Held by Corporate Partner

The Act amends Section 755 to provide that, upon a distribution in liquidation of a partner's interest in a partnership, a partnership is precluded from decreasing the basis of the stock of a corporate partner (or a related person to the corporate partner). Instead, any decrease in basis that would have been allocated to such stock is allocated to other partnership assets.

The partnership will recognize gain to the extent that a decrease in the basis of the other partnership assets exceeds the current basis of such assets. Prior to amendment, a partnership could make an election to adjust its basis in all partnership property in the case of a distribution of partnership property. This provision is effective for distributions after the date of enactment of the Act.

Recognition of Cancellation of Indebtedness Income on Satisfaction of Debt with Partnership Interest

The Act amends Section 108 to provide that a partnership will recognize cancellation of indebtedness income if it transfers a capital or profits interest in the partnership to a creditor in satisfaction of partnership debt and the fair market value of the transferred interest is less than the amount of the debt. The cancellation of indebtedness income will be recognized solely among partners that hold an interest in the partnership immediately prior to the satisfaction of the debt. Currently, if a corporation transfers shares of its stock in satisfaction of its debt (and the fair market value of its stock is less than the amount of the debt), the corporation must recognize cancellation of indebtedness income. Prior to the Act, it was unclear whether a partnership was required to recognize income in such cases. This provision is effective for cancellations of indebtedness occurring on or after the date of enactment of the Act.

REAL ESTATE INVESTMENT TRUSTS

The Act both relaxes some and makes more restrictive other rules applicable to real estate investment trusts ("REITs") and their shareholders.

Qualification of a REIT

Under current law, an entity must meet various tests in order to qualify as a REIT, including income and asset tests. The asset tests limit the amount of securities a REIT can own. Certain "straight debt" instruments are not treated as securities for these purposes. The Act amends Section 856 to expand the straight debt safe harbor for purposes of the asset test.

Under current law, at least 95 percent of a REIT's annual gross income must come from certain passive sources (the "95 percent test") and at least 75 percent of its annual gross income must come from certain real estate activities (the "75 percent test"). The Act amends Section 856 in the following manner:

- changes the treatment of certain income from hedging activities from good income for purposes of the 95 percent test, to neutral income and conforms the definition of hedging activities to Section 1221; and
- creates testing dates to determine whether rents received by a REIT from a taxable REIT subsidiary are at arm's length.

The Act also amends Section 857(b)(7)(B)(ii) to eliminate the redetermined rents safe harbor.

In addition, the Act allows a REIT to avoid disqualification for failure to meet certain requirements provided, generally, that (i) failure is due to reasonable cause and not willful neglect, (ii) the REIT pays a penalty or a tax associated with the failure, except for certain failures not exceeding a specified de minimis amount and (iii) the failure is corrected. The relief provisions are limited and do not apply in all circumstances.

Taxation of a REIT

Under current law, a 100 percent tax will be imposed on the net income of a REIT derived from "prohibited transactions." Prohibited transactions generally include the sale or disposition of property held for sale in the ordinary course of a trade or business. The Act amends Section 857 to provide that if certain criteria are met, sales of REIT timber property will not constitute prohibited transactions and will qualify as good income for purposes of the 75 percent and 95 percent tests.

Taxation of Foreign REIT Shareholders

The Act exempts from the "FIRPTA" tax imposed by Section 897 certain capital gain distributions from REITs, where the REIT stock is traded on an established securities market located in the United States and where the foreign shareholder does not own more than 5 percent of such stock at any time during the year. The provision would treat such distributions similarly to regular REIT dividends rather than as capital gain dividends.

Effective Dates

The provisions of the Act regarding REITs are generally effective for taxable years beginning after the date of enactment, while the expanded "straight debt" provision and new testing dates for the 90 percent requirement are effective for taxable years beginning after December 31, 2000.

REGULATED INVESTMENT COMPANIES

The Act liberalizes rules applicable to regulated investment companies ("RICs") and their shareholders in several ways.

Definition of a RIC and Treatment of RIC Shareholders

Under current law, a RIC investing in a publicly traded partnership ("PTP") is generally deemed to earn a proportionate share of the PTP's income, which could include income that would not qualify for the 90 percent gross income test (e.g., rental income).[7] For taxable years

[7] In order for an entity to qualify as a RIC, at least 90 percent of its gross income must be from certain passive sources.

beginning after the date of enactment, the Act amends Sections 851 and 469 to provide that qualifying income for purposes of the 90 percent gross income test includes income derived from an interest in a PTP. However, the aggregate value of a RIC's holdings in PTPs may not exceed 25 percent of its total value. Any losses passing through to a RIC from a PTP would be subject to the passive loss rules. These amendments apply to taxable years beginning after the date of enactment of the Act.

Treatment of Certain Shareholders of RICs

The Act amends Sections 871, 881, 1441 and 1442 for taxable years beginning after December 31, 2004 and before January 1, 2008, to allow a RIC to designate the appropriate amounts of a dividend as an "interest-related dividend" and/or a "short-term capital gain dividend." Provided that certain requirements are met, an interest-related dividend or a short-term capital gain dividend received by a foreign person will be exempt from U.S. withholding tax under these sections. In addition, the Act amends Section 897 to provide that a foreign person will not be subject to FIRPTA tax on the sale of RIC shares if the RIC is owned 50 percent or more by U.S. persons.

Estate Tax Treatment of Interests in Certain RICs

The Act amends Section 2105 to provide that a portion of the stock in a RIC held by an estate of a nonresident decedent who is not a U.S. citizen will be exempt from U.S. estate tax. The portion excluded would be based upon the proportion of "qualifying assets" held by the RIC at the end of the quarter immediately preceding the decedent's death. Qualifying assets include bank deposits of the type exempt from foreign withholding, portfolio debt obligations, certain original issue debt obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the U.S. This provision applies to estates of decedents dying after December 31, 2004 and before January 1, 2008.

NONQUALIFIED DEFERRED COMPENSATION PLANS

The Act adds Section 409A to provide specific requirements to avoid constructive receipt of income under plans that provide for the deferral of compensation, and to establish the consequences to plan participants for failure of the plan to meet such requirements. Section 409A applies to a broad scope of deferred compensation arrangements and sets forth the following requirements for deferral:

- *Distributions*. Distributions from the plan are only allowed upon (i) a separation from service, (ii) a death, (iii) pursuant to a fixed schedule or at a specified time, (iv) upon a change in control of the corporation, (v) upon the occurrence of an unforeseeable emergency or (vi) if the participant becomes disabled. In the case of key employees of publicly traded corporations, distributions upon separation from service may not be made earlier than six months after the date of the separation from service.

- *Acceleration*. Acceleration of distributions is generally not permitted. Treasury regulations will be promulgated to provide limited exceptions to this rule.
- *Timing of Elections*. Compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than at the close of the preceding taxable year, or at such other times provided in Treasury regulations. In the case of performance-based compensation for services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period.

If impermissible distributions or elections are made, or if the nonqualified deferred compensation plan allows impermissible distributions or elections, all amounts deferred under the plan (including amounts deferred in prior years) are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in income. In addition, interest and additional tax is payable with respect to deferred amounts to the extent that such deferred amount would have been includable in a previous year.

These provisions are effective for amounts deferred in taxable years beginning after December 31, 2004. For purposes of the effective date, an amount is considered deferred before January 1, 2005 if the amount is earned and vested before such date.

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The provisions of the Act are more complex in their entirety. The foregoing is a general summary only, and not intended as tax advice. Please contact Steven C. Todrys (212-455-3750; stodrys@stblaw.com), John C. Hart (212-455-2830; jhart@stblaw.com), John J. Creed (212-455-3485; jcreed@stblaw.com); Dickson G. Brown (212-455-2850; dbrown@stblaw.com), Charles O. Rappaport (212-455-2548; corappaport@stblaw.com), Robert Holo (212-455-2514; rholo@stblaw.com), Gary B. Mandel (212-455-7963; gmandel@stblaw.com) or any other member of our tax department if you have questions or comments.

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