

JANUARY 2005

Client Bulletin

BUSINESS & TAX PLANNING IDEAS for OUR CLIENTS and FRIENDS

What Will the American Jobs Creation Act Mean to You?

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (AJCA), which changes the taxation of foreign business income and provides incentives for manufacturers. It also contains other provisions affecting individuals and businesses, particularly S corporations. Most of the AJCA takes effect in 2005 or later, but there are exceptions. Some of the provisions most important to individuals and small businesses are discussed below.

Individual provisions

Deducting sales and use taxes. For tax years 2004 and 2005, you can deduct state and local sales and use taxes in lieu of state income taxes. You can deduct either actual sales and use taxes or use IRS published tables that will be based on income, number of dependents, and other factors. Sales taxes on motor vehicles and boats can be added to the IRS table amounts. Taxpayers in states without individual income taxes or with a limited individual income tax will benefit under the new provision.

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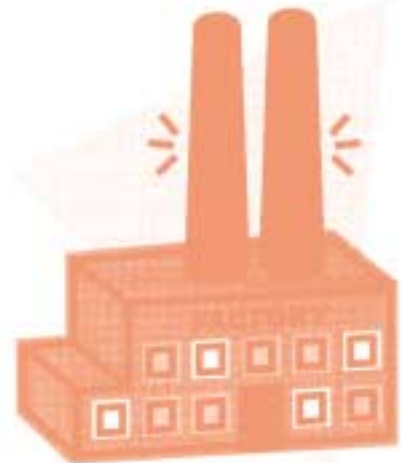
Did You Know?

It has been estimated that, of the 31 billion emails sent daily in 2003, 12.4 billion were spam, which cost Internet users \$255 million.

CPASM

America Counts on CPAs

Principal residence exclusion disallowed after like-kind exchange. The \$250,000 exclusion (\$500,000 for married couples filing jointly) of gain on a sale or exchange of a personal residence will not apply if you received the residence in a like-kind exchange within five years before the sale. This new rule applies to exclusions for sales or exchanges after October 22, 2004.



General business provisions

U.S. production activities deduction. The main thrust for enacting the AJCA was elimination of the extraterritorial income (ETI) exclusion, which benefited U.S. exporters and angered the European Union. The AJCA repeals the ETI for transactions occurring after 2004 and replaces it with a new deduction for taxpayers with qualified production activities income (QPAI). The QPAI deduc-

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tion equals the lesser of a percentage of a taxpayer's (1) QPAI for the tax year or (2) taxable income (adjusted gross income, with modifications, if an individual). While the percentage is 3% in 2005 and 2006, 6% in 2007 through 2009, and 9% in 2010 and thereafter, generally, a taxpayer cannot deduct more than 50% of the W-2 wages it paid for the year.

The law provides some transitional relief through 2006, allowing certain taxpayers to retain a portion of their old ETI benefits. The old ETI exclusion also remains in effect for certain transactions existing as of September 17, 2003.

Nonqualified deferred compensation. Executive compensation plans are under increased scrutiny in view of recent corporate scandals. Thus, the AJCA provides rules to discourage a plan participant's inappropriate control of or access to deferred compensation without income recognition. A participant's nonqualified deferred compensation for the tax year (and all previous tax years) will be includible in income to the extent (1) not subject to a substantial risk of forfeiture, (2) not previously included in gross income, and (3) the plan fails specified requirements for distributions, acceleration of benefits, and elections at any time during the year. Includible income will be subject to reporting and withholding requirements.

Previously, inclusion depended on the facts and circumstances and legal doctrines. For unfunded arrangements, the nonqualified deferred compensation generally was included when it was actually or constructively received. For funded arrangements, it was includible when the individual's rights were transferable or not subject to a substantial risk of forfeiture.

A nonqualified deferred compensation plan is any plan other than a qualified plan or vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. For example, nonqualified plans could include salary and bonus deferral plans, stock options and appreciation rights, but not incentive stock options and options granted under employee stock purchase plans.

The restrictions on distributions, acceleration of benefits, and elections are complicated; plans generally must comply for amounts deferred after 2004. However, IRS guidance will allow a limited opportunity to amend plans existing before 2005, so that an individual can terminate plan participation or cancel a deferral election.

Expanded expense election. The election to expense up to \$100,000 of depreciable tangible personal property under section 179 is extended. The annual \$100,000 cap was scheduled to revert back to \$25,000 at the end of 2004, but now applies through the end of 2007. In addition, the reduction in the annual cap for the amount of qualifying property in excess of \$400,000 is extended until 2007. Both the \$100,000 limit and the \$400,000 phase-out will continue to be indexed for inflation. Also, the election is extended to off-the-shelf software, and taxpayers can revoke a section 179 election (without IRS consent), through 2007.

SUV expensing. For sport utility vehicles (SUVs) you place in service after October 22, 2004, the amount you may expense under section 179 in the first year is subject to a \$25,000 cap, not indexed for inflation. Previously, SUV expensing was subject only to the \$100,000 limit, indexed for inflation (\$102,000 for 2004).

In general, an SUV is a four-wheeled passenger vehicle weighing less than 14,000 pounds. However, vehicles hav-

ing a seating capacity of more than 9 persons or having an open cargo area of 6 feet, and other truck-type vehicles, are excluded from the reduced expensing rule.

Leasehold and restaurant improvements depreciation. Qualified leasehold improvements and restaurant property placed in service after October 22, 2004, and before 2006 are now classified as 15-year (rather than 39-year) recovery property under the modified accelerated cost recovery system (MACRS). Pre-2004 leasehold improvements are depreciable over the MACRS recovery period for the particular improvement, even if longer than the lease.

Qualified leasehold improvement property generally has the same meaning as it does for bonus depreciation purposes. However, a lessor's improvement is qualified only if the lessor holds it, except in the case of death and certain specified transactions. Qualified improvements must be depreciated under the straight-line method. Pre-October 22, 2004, 15-year property generally is depreciated under the 150%-declining-balance method.

Qualified restaurant property is an improvement to a building if it is section 1250 property, it is placed in service more than three years after the building, and more than 50% of the building is used for preparation and seating for the consumption of meals. Such restaurant property must be depreciated under the straight-line method and is eligible for first-year bonus depreciation as 15-year property. For ADS (alternative depreciation system) purposes, it has a class life of 39 years.

Deducting organizational/start-up costs. A corporation or partnership can elect to deduct up to \$5,000 of its organizational expenditures in the year it begins business, if paid or incurred after October 22, 2004. This limit is

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Organizational expenditures for corporations include legal and accounting services incident to organization, state incorporation fees, and expenses of temporary directors and organizational meetings. For partnerships, these costs include filing fees and legal and accounting fees incident to organization, such as negotiation and preparation of the partnership agreement. If the partnership is liquidated, any unamortized expenditures can be a deductible loss.

The same rules apply to start-up expenditures of corporations and partnerships, which include the costs of investigating the acquisition or creation of an active trade or business and its actual creation.

S corporation provisions

These reforms are generally effective for tax years beginning after 2004.

Election to treat family members as one shareholder. Family members can elect to be treated as one shareholder in determining the overall number of S corporation shareholders. For purposes of computing the number of shareholders, corporations are permitted to elect to treat all members of a family (up to six generations) as one shareholder.

Increase in maximum number of eligible shareholders. The maximum number of eligible shareholders in an S corporation is increased from 75 to 100. Eligible shareholders include individuals who are U.S. citizens or residents, estates, and certain types of trusts. This provision will allow more corporations and their shareholders to enjoy the benefits of S corporation status.

Transfers of suspended S losses to spouse or former spouse. Any loss or deduction that isn't allowed to a shareholder of an S corporation because it exceeds the shareholder's basis in stock or debt of the corporation, is treated as incurred by the S corporation with respect to that shareholder in the subsequent tax year. Under the new law, if a shareholder's stock in an S corporation is transferred to a spouse or to a former spouse in a divorce, any suspended loss or deduction relating to that stock is transferred to (and may be carried over by) the transferee spouse.

Relief from inadvertently invalid QSub elections and terminations. Inadvertently invalid qualified subchapter S subsidiary (QSub) elections and terminations can be waived by the IRS. To obtain relief, the QSub and the S corporation parent must, within a reasonable time after discovering the circumstances causing the invalidity, (1) take steps so that the corporation qualifies as a QSub and (2) agree to IRS-prescribed adjustments consistent with the treatment of the corporation as a QSub during the relevant period.

SESOP's payment of loans for stock. An S corporation's employee stock ownership plan (SESOP) may use distributions on the S stock it owns to repay loans used to purchase the stock. If the SESOP's provisions provide for such use of the distributions, the SESOP will not be treated as violating the Code's qualified plan requirements or prohibited transaction rules. In general, the securities cannot be allocated to participants, unless the SESOP provides that employer securities with a fair market value greater than the distribution amount are allocated to the participant for the year in which the distribution would otherwise have been allocated. The new law applies to distributions on S stock after 1997. Previously, only C corporations had been allowed to repay such loans with dividends.

QSub information returns. A corporation whose stock is held by an S corporation is treated as a QSub if the S corporation so elects. The QSub's assets,

liabilities, and items of income, deduction, and credit are treated as the parent's. Under the new law, the IRS may require QSubs to file information returns.

Charitable deduction provisions

Abusive vehicle charitable contributions. The charitable deduction for a post-2004 contribution of a motor vehicle, boat, or airplane resold by a charity is limited to the gross proceeds received by the charity, instead of the full Blue Book value. There is an exception if the charity made significant use of the item in conducting its activities or made material improvements to it before sale.



Increased reporting for noncash charitable contributions. C corporations will now be subject to a rule that if a charitable gift of property other than cash, inventory, or publicly traded securities exceeds \$5,000, a qualified appraisal is required. In addition, if a contribution—by any taxpayer—of such property exceeds \$500,000, the donor must attach a qualified appraisal to its tax return. A donor that fails to substantiate a charitable contribution of property will be denied the deduction. These rules are effective for contributions made after June 3, 2004.

Miscellaneous provisions

Installment agreements for partial payments of tax. The IRS can enter into taxpayer installment agreements that do not provide for full payment of the taxpayer's liability over the life of the agreement. It is required to

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review partial payment installment agreements at least every two years to determine whether the taxpayer's financial condition has significantly changed, so as to warrant an increase

in the amount of the payments being made. Further, the IRS need not accept mandatory installment agreements providing less than full payment. This provision is effective for installment agreements entered into after October 21, 2004.

Recommendation

The AJCA also includes other provisions that will be discussed in future issues. In the meantime, please call us with any questions you might have about the new law.

Tax Calendar

JANUARY 2005

January 10

Employees who work for tips. If you received \$20 or more in tips during December, report them to your employer. You can use Form 4070.

January 18

Individuals. Make a payment of your estimated tax for 2004 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2004 estimated tax. However, you do not have to make this payment if you file your 2004 return and pay any tax due by January 31, 2005.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December if the monthly rule applies.

January 31

All businesses. Give annual information statements to recipients of certain payments you made during 2004. Payments that are covered include: (1) compensation for workers who are not considered employees, (2) dividends and other corporate distributions, (3) interest, (4) amounts paid in real estate transactions, (5) rent, (6) royalties, (7) amounts paid in broker and barter exchange transactions, (8) payments to attorneys, (9) profit-sharing distributions, (10) retirement plan distributions, (11) original issue discount, (12) prizes and awards, (13) medical and health care payments, (14) debt cancellation (treated as payment to debtor), and (15) cash payments over \$10,000. There are different forms for different types of payments.

Employers. Give your employees their copies of Form W-2 for 2004.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2004 on all nonpayroll items, such as backup withholding, and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2004. For all taxes, deposit any undeposited tax. If the total is less than \$2,500 and not a shortfall, you can pay it with the return. If you deposited the tax for the quarter in full and on time, you have until February 10 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2004. If your undeposited tax is \$100 or less, you can either pay it with your return or deposit it. If it is more than \$100, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 10 to file the return.

Individuals. If you did not pay your last installment of estimated tax by January 18, you can avoid any late payment penalty by filing your income tax return for 2004. Filing your return and paying any tax due by January 31 prevents any penalty for late payment of the last installment.

FEBRUARY 2005

February 10

Employees who work for tips. If you received \$20 or more in tips during January, report them to your employer. You can use Form 4070.

February 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in January if the monthly rule applies. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2004, but did not give you a new Form W-4 to continue the exemption for 2005.

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

February 28

All businesses. File information returns (Form 1099) for certain payments you made during 2004. These payments are described under January 31. If you file Forms 1099 electronically (not by magnetic media), your due date for filing them with the IRS is March 31.

Employers. File Form W-3, along with Copy A of all the Forms W-2 you issued for 2004. If you file Forms W-2 electronically (not by magnetic media), your due date for filing them with the Social Security Administration (SSA) will be extended to March 31.