Advanced Planning Strategies

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Dear Reader,

The fall legislative season has brought an uncommon amount of tax changes for an election year. We reported briefly last month on the "Working Families Tax Relief Act of 2004." Even tax professionals were caught somewhat by surprise at both the passage and scope of "The American Jobs Creation Act of 2004" (H.R. 4520) approved by Congress last month and signed into law by the President. Interestingly, both bills appeared to have hit snags and were supposedly doomed one day and solved by compromises on the next day.

The American Jobs Creation Act began as a corporate tax relief provision for exporters, but it grew into a $145 billion tax cut purportedly for corporations. The bill also includes many provisions that apply to individuals and noncorporate business entities. The tax cuts are offset by some revenue raisers that will not please some affected taxpayers. Some parts of the act have consequences that will go back prior to the date of enactment, so immediate action is required.

The act and the Congressional report are each 600 or more pages long and have been in our hands only a few days at the time this letter was written. We have selected certain key provisions to discuss. In later reports, we'll try to incorporate more detail about key provisions—notably a major amendment to deferred-compensation rules. You should read the inside report if you (1) operate a business that is engaged in manufacturing, (2) own stock in an S corporation, (3) donate or have donated a vehicle or other noncash items to charity, (4) have purchased or plan to purchase property to be used in a trade or business, and (5) paid state and local sales taxes and itemize deductions.

SELECTED PROVISIONS OF THE AMERICAN JOBS CREATION ACT OF 2004

NEW LOWER TAX RATE FOR QUALIFIED PRODUCTION ACTIVITIES

Beginning in 2005, there will be a tax deduction for business income derived from domestic manufacturing and production. The initial deduction is 3 percent in 2005 and 2006. The deduction increases to 6 percent in 2007, 2008, and 2009, and it will increase to 9 percent thereafter. This deduction applies, regardless of the form of business entity. For example, the deduction can be taken by an entity that is a separate taxpayer, such as a regular corporation. The deduction can also be taken on an individual return against pass-through income from an S corporation, partnership, limited liability company, estate, trust, or sole proprietorship.

Domestic production activities include manufacturing, food processing, film or videotape production, energy production, engineering, construction, and computer software production. The property must generally be manufactured, produced, grown, or extracted at least in significant part within the United States. In the case of films or videos, at least 50 percent of the compensation provided to the actors, production personnel, directors, and producers must be for services performed in the United States. Excluded from the allowable production activities are the sale of food and beverages prepared by the taxpayer at a retail establishment and the transmission of electricity, gas, or water.

The allowable deduction for the year (3 percent in 2005) is applied to the lesser of (1) the “qualified production activities income” or (2) the taxpayer’s taxable income (determined without regard to the deduction). The deduction is further limited to 50 percent of the wages paid by the employer engaged in the activity. Wages include normal wages and certain elective deferrals under retirement plan arrangements.

NEW QUALIFICATION RULES FOR S CORPORATIONS

S corporations are taxed as pass-through entities for federal (and some state) income tax purposes. They are popular for business owners who wish to be taxed at the individual tax level for business income and have the liability shelter of a corporation. Limitations on both the number and type of shareholders have always been in the law and have been amended before. Failure to qualify could result in disqualification and taxation as a regular corporation, in many instances increasing the tax burden.

The maximum allowable number of shareholders in an S corporation has been increased from 75 to 100. In addition, for the purposes of this test, all members of the same family are treated as one shareholder. Members of the family include a common ancestor and all lineal descendants of the common ancestor (including spouses and former spouses of such individuals). To be counted as members of a family, the youngest generation of such lineal descendants cannot be more than six generations removed from the common ancestor. In addition, certain trusts are eligible to be shareholders of S corporation stock. The electing small business trust (ESBT) and qualified subchapter S trust (QSST) will be treated as family members for this purpose. The law also removed one of the disadvantages of the ESBT that is used as a family trust for estate planning purposes. Under the new law, a beneficiary can be given a broad power of appointment over the ESBT’s benefits without all potential recipients of an unexercised power counting against the shareholder limit. The law makes it easier for a multigeneration family corporation to maintain an S election. These rules apply after 2004.

NEW CHARITABLE DONATION REQUIREMENTS

Limits on Charitable Deduction for Motor Vehicles, Boats, and Airplanes. The recent popularity of donating such items to charity has created some concern over the abuse of the value of the donated item for tax purposes. Beginning with contributions in 2004, there is a new requirement that imposes a substantiation burden and penalty on the charity. The deduction will be limited to the amount (gross sale proceeds) at which the charity sells the property after receiving the donation unless the vehicle is used significantly (or improved) by the charity. The charity is required to provide substantiation to the donor within 30 days of the sale. In the case of a fraudulent acknowledgement, the charity is subject to a tax penalty equal to the greater of the gross sale proceeds received by the charity or the highest income tax rate for individuals applied to the sales price stated on the contemporaneous acknowledgement.

Limits on Charitable Deduction for Donations of Patents or Intellectual Property. For contributions of patents or other intellectual property, the donor's deduction will be limited to the lesser of adjusted basis or fair market value. This product includes patents, copyrights, trademarks, trade names, trade secrets, and software (there is an exception for certain property held as inventory). However, the donor will also be able to deduct the income received by the charity from the property subsequent to the donation. The deduction for income is limited to a decreasing applicable percentage of the income as defined in the code. This provision applies to donations after June 3, 2004.

New Substantiation Rules for Contributions of Property. Property donations have traditionally required additional substantiation (Form 8283) on the tax return if the property deducted exceeds $500, with a larger burden of a qualified appraisal for most property valued at more than $5,000. The new law adds this burden to corporations for corporate donations. In addition, the qualified appraisal report must be included with the tax return for a donation of property that exceeds $500,000. The substantiation rules do not apply to cash, inventory, publicly traded securities, and vehicles for which the charity must provide an acknowledgement of the sale price to the donor as described above. This rule applies to donations after June 3, 2004.

EXPENSING OF PROPERTY USED IN A TRADE OR BUSINESS

Section 179 Expensing Limit Extended. A small business may elect to deduct expenditures for investment in tangible personal property currently rather than depreciating the expenditure over a specified period of years. The increased limit of $100,000 for a currently deductible amount provided by the 2003 act was extended through 2007. The amount that can be deducted currently is reduced after the taxpayer reaches $400,000 for such investments. Both the $100,000 limit and the $400,000 reduction threshold are indexed for inflation ($102,000 and $410,000 in 2004).

Leasehold or Restaurant Property Improvements Depreciable over 15 Years. The new law allows faster depreciation of expenditures for leasehold improvements. It permits straight-line depreciation over 15 years, rather than the 39-year period under prior law. The limit applies whether or not the depreciation period exceeds the lease term. If the lessor made the leasehold improvement, any successor tenants will not be treated as holding a qualified leasehold improvement for this purpose unless the transfer resulted from death or a tax-free exchange. Qualified restaurant property is depreciable in the same manner if the improvement causes more than 50 percent of the property to be devoted to the preparation and on-premise consumption of meals. To qualify for the 15-year recovery period, the property must be placed in service before January 1, 2006.

Depreciation of SUVs Used for Business Purposes Limited. Prior law created an attractive expensing option for certain SUVs (covered in earlier editions of this letter). The first-year Section 179 expensing limit for vehicles that meet the definition is reduced to $25,000. Included in this definition are SUVs that are (1) 4-wheel drive, (2) 14,000 pounds or less, and (3) primarily designed or that can be used to carry passengers on public

roads. Excluded from the limit are vehicles designed for more than nine passengers behind the driver's seat and vehicles with specified cargo space or enclosures. This limit applies to vehicles placed in service after the bill is signed into law.

NEW DEDUCTION FOR STATE SALES TAXES

A handful of states do not have a state income tax. Congress provided a benefit for such states by creating a deduction for state and local sales taxes paid. This deduction is allowable in lieu of a deduction for state and local income taxes for taxpayers itemizing deductions. This deduction may also be helpful for individuals who make large purchases during a tax year and have a sales tax burden that would exceed their deductions for income taxes. However, for taxpayers facing or near the alternative minimum tax (AMT) burden, this deduction will not reduce the AMT base and tax liability.

A burden has been created by this provision that is obvious if you're paying attention. Simply, how does the taxpayer keep records of the sales taxes paid? The law provides an option to keep receipts and records of actual sales taxes paid. In lieu of the actual receipts, the IRS is directed to provide tables that create proxy deduction limits based on the average consumption levels of state taxpayers, the filing status, number of dependents, adjusted gross income levels, and the general rate of sales taxes for the state. The taxpayer is expected to be able to add actual sales taxes on specific large-ticket items, such as boats or motor vehicles, where record keeping is not such a burden. If the state has lower rates for items such as food or clothing, and higher rates for vehicles, the general sales tax rate on all items will be used. This deduction is allowable in 2004 and 2005. Of course, Congress recognizes that it will be difficult for the IRS to prepare tables for 2004 tax returns that are already in production. The IRS is directed to "do the best they can to reasonably and accurately implement this statutory provision."

This deduction also applies to use taxes if the state has a use tax complimentary to its general sales tax. This deduction could provide some year-end planning opportunities if the taxpayer is considering some large purchases.

CONCLUSION

Some provisions of the new act are somewhat thin in details (amazing for a 600-page act). Many provisions instruct the Treasury to draft regulations to fill in the blanks. It is clear that the conferees were under some time pressure to incorporate the inevitable final compromises. We'll keep you posted as the regulations are issued.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

Positioning our clients for the future

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