

**SWEEPING NEW TAX CHANGES ENACTED:  
WHAT TAXPAYERS AND THEIR ADVISORS NEED  
TO KNOW ABOUT THE AMERICAN  
JOBS CREATION ACT OF 2004**

**October 2004**

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On October 22, 2004, the President signed into law one of the most significant packages of tax legislation in decades, the American Jobs Creation Act of 2004 (or Jobs Act). With the enactment of this new legislation, a U.S. regime of tax subsidies that has been deemed illegal by the World Trade Organization has been repealed and, in its place, a broad array of domestic and foreign tax provisions have been enacted that should provide very significant tax benefits for many U.S. businesses, particularly those engaged in either domestic production activities or cross-border trade. These favorable tax provisions will be accompanied, however, by the most sweeping anti-tax shelter provisions enacted in decades. Furthermore, many taxpayers may encounter significant complexity as they navigate the numerous transitional issues that the Jobs Act implicates.

In order to make taxpayers aware of the most important provisions of the Jobs Act, below we have set out (1) an Executive Summary of the new rules and (2) a very brief, non-technical overview of the portions of the Jobs Act most significant to the vast majority of Morgan Lewis' clients. While the brevity of our summary will aid taxpayers in obtaining a quick overview of the new law, it should be remembered that many of these provisions are complex and will require substantial scrutiny if taxpayers hope to enjoy their benefits.

**EXECUTIVE SUMMARY**

The Jobs Act represents a stated Congressional purpose of making U.S. businesses, and manufacturers in particular, more competitive on a global scale while also addressing what is widely perceived as an explosion of abusive tax shelters. Accordingly, the Act contains both provisions that expand the availability of tax-favorable treatment and portions mandating aggressive new disclosure and penalties for tax shelter transactions.

***Rules that will liberalize and simplify compliance and, in many cases, significantly reduce taxpayers' tax liabilities include:***

- The introduction of reduced tax rates for domestic production activities and permanently repatriated foreign earnings;
- The dramatic liberalization and simplification of the foreign tax credit rules;
- The narrowing and elimination of numerous elements of the various, overlapping U.S. anti-deferral regimes applicable to foreign earnings; and

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- The introduction of new provisions relating to REITs, RICs, and S corporations that should ease qualification requirements in many instances, while demanding heightened attention to qualification in a few cases.

*Rules that will attack and penalize abusive tax transactions include:*

- New penalty provisions intended to punish or effectively thwart U.S. taxpayers who attempt to expatriate some or all of their operations in order to avoid the imposition of U.S. tax on their worldwide income.
- A broad array of information disclosure and penalty provisions aimed at listed and reportable transactions and other tax shelters, their participants, and their promoters and advisors.

## **OVERVIEW OF THE JOBS ACT OF 2004**

### **Reduced Tax Rates**

*Limited-Time, 5.25% Rate for Permanent Repatriation of Foreign Earnings*

The Jobs Act will allow a one-time election to claim an 85% deduction (which generally should result in an effective 5.25% tax rate, rather than the current 35% rate) for certain dividends received by a U.S. corporation from a controlled foreign corporate subsidiary during either the first tax year beginning after or the last tax year beginning before October 22, 2004 (the Jobs Act's enactment date). Qualification for the deduction will require taxpayers to satisfy a complex set of requirements, including that the dividend at issue be repatriated in accordance with a "domestic reinvestment plan" approved of by the taxpayer's senior management and board of directors. The amount of dividends eligible for the deduction may not exceed the greater of either \$500 million or the amount of earnings shown as permanently reinvested outside of the U.S. on the taxpayer's most recently audited financial statement which is certified on or before June 30, 2003. **This rule provides an excellent opportunity for many corporate taxpayers to consider repatriating some of their foreign earnings to make acquisitions.**

*Incentive for U.S. Production Activity*

A new deduction, which will initially be 3% and eventually will rise to 9%, will be allowed with regard to a broad array of domestic manufacturing and production activities undertaken by taxpayers, regardless of their form of business operations. **While this effective reduction in tax rates should be welcomed by most taxpayers, the reduction is dependent upon the satisfaction of a number of complex requirements and, accordingly, will present taxpayers with significant, initial uncertainties regarding their qualification to claim the new, reduced tax rates.**

## International Tax Reform

### *Liberalization and Simplification of Foreign Tax Credit Rules*

The Jobs Act's most important international tax reforms are those relating to the foreign tax credit (FTC) regime. Taxpayers generally may claim a credit for foreign taxes that they pay against their U.S. tax liability on the same items of foreign income. Under current law, complex and sometimes unfair rules relate to the calculation of the amount of FTCs that taxpayers can claim in any given year and to taxpayers' rights to carry excess FTCs to other years. The Jobs Act significantly liberalizes the process of calculating and claiming FTCs and should prove to be a boon to any business engaged in cross-border operations. Notable new provisions include:

- Replacement of the prior-law 2-year carryback/5-year carryforward period for excess FTCs with a 1-year carryback/10-year carryforward period. **This new rule should significantly reduce the instances where taxpayers' excess FTCs expire unused.**
- Currently, FTCs must be allocated to 9 different income baskets, to prevent taxpayers from inappropriately "cross-crediting" and thereby reducing their U.S. income tax liability. The Jobs Act replaces these 9 baskets with 2 income baskets. **While this change should remove much complication for taxpayers that claim FTCs, many taxpayers will need significant guidance as they strive (1) to deal with formidable transitional issues and (2) to determine to which of the 2 baskets to allocate various items of income and associated deductions.**
- Rules that should result in an increase in the annual amount of FTCs that may be claimed. These rules primarily focus on the calculation of the annual limitation that is imposed upon FTCs and include special provisions that will recharacterize certain domestic income as foreign income and will decrease the proportion of a multinational group's interest expense that is allocated against foreign income. Additionally, the Jobs Act repeals the 90-percent limitation on the use of FTCs against taxpayers' alternative minimum tax liability.
- Rules clarifying that U.S. corporations that own foreign corporations through partnerships are entitled to claim FTCs for taxes paid by such foreign corporations.

Counterbalancing the generous FTC reforms discussed above, the Jobs Act also introduces new limitations on the exploitation of FTCs. The most significant are (1) the imposition of new minimum holding periods for certain property (such as debt instruments or license agreements) in order for taxpayers to claim FTCs for foreign taxes withheld on the payment of income related to such property (such as interest or royalties) and (2) a new rule requiring the recognition of gain on many dispositions of the stock of foreign corporations that formerly would not have resulted in a U.S. tax liability. **Taxpayers engaged in cross-border borrowing, licensing, and business structuring need to be carefully advised regarding these dangerous traps for the unwary.**

### *Liberalization of the Rules Applicable to Controlled Foreign Corporations (CFCs)*

U.S. taxpayers that own interests in certain foreign corporate subsidiaries (such as a subsidiary in which they own 51 percent of the voting power) must pay current U.S. tax on their allocable share of certain items of foreign income (so-called Subpart F income) that would not otherwise be subject to any U.S. tax unless actually repatriated.

The Jobs Act liberalizes these anti-deferral rules by:

- Excluding from the definition of Subpart F income: (1) many income items realized by a CFC from or in connection with the use, hiring, or leasing of a vessel or aircraft in foreign commerce; (2) a broader array of income from commodities transactions; (3) additional types of income derived from the active conduct of a banking, financing, or similar business (these exclusions will be on a temporary basis); and (4) income deemed to arise out of the act of holding certain U.S. securities or other obligations.
- Allowing CFCs to sell partnership interests without automatically treating the gain as Subpart F income.

In one respect, however, the definition of Subpart F income has been broadened; it now includes certain income relating to personal services contracts.

### *Repeal of Other Anti-Deferral Regimes Applicable to Foreign Corporations*

In addition to the CFC anti-deferral rules described above, the Code has long imposed various other anti-deferral regimes. The Jobs Act repeals two of these regimes (the Foreign Personal Holding Company and Foreign Investment Company regimes) and makes a third (the Personal Holding Company regime) inapplicable to foreign corporations. **While these changes will likely not have a great impact upon the amount of taxes paid by foreign corporations or their U.S. owners (because of the continued operations of other anti-deferral regimes), they will greatly reduce administrative and other compliance burdens of U.S. taxpayers that are engaged in cross-border operations.**

### **Changes to the REIT, RIC, and S Corporation Rules**

#### *Real Estate Investment Trusts*

REITs are tax-favored structures that facilitate investment in real estate at a reduced tax cost. In order to qualify for tax benefits, however, a REIT must satisfy 4 requirements on an annual basis: (1) an asset requirement; (2) an income requirement; (3) an income distribution requirement; and (4) an organizational requirement. A REIT that fails any of these requirements must generally face the same tax consequences normally imposed on a corporation. This, in effect, means the imposition of a second, corporate-level of tax on the income that the

disqualified REIT earns and distributes to its shareholders (who, themselves, already pay tax on such income).

The Jobs Act introduces a number of important changes affecting the ease with which an entity can become and remain classified as a REIT. The asset requirement has been liberalized, so that a REIT can meet this test more easily and hold a broader array of assets. Modifications have also been made to the income test with regard to the treatment of hedging gains and rents received from so-called taxable REIT subsidiaries. The Jobs Act also provides greater relief for a REIT that fails any of the 4 qualification requirements to avoid disqualification.

**A final notable change is the introduction of new rules that will significantly reduce the U.S. taxes imposed on many foreign investors in REITs.**

### *Regulated Investment Companies*

Like a REIT, a RIC (also known as a mutual fund) is a tax-favored investment vehicle. The Jobs Act introduces rules that should significantly ease the amount of tax imposed on foreign investors in U.S. RICs. **As in the case of REITs, RICs that have or anticipate having foreign investors should be aware of these very favorable changes and modify their disclosure documentation accordingly.**

In addition, new provisions address situations where a RIC invests in a so-called publicly traded partnership and replace the current look-through regime with one that generally treats interests in such partnerships as the equivalent of corporate stock. In many cases, this should make it easier for a RIC to invest in such a partnership while retaining its tax-favored status.

### *S Corporations*

S corporations are small business corporations that are generally accorded flow-through treatment on their income, so that they and their shareholders are only subject to 1 level of tax, rather than the 2 levels of tax imposed upon income earned by most other corporations. A corporation that is wholly owned by an S corporation may elect to be treated as a so-called qualified subchapter S subsidiary, so that its assets, liabilities, and tax items are treated as belonging directly to its S corporation parent.

The Jobs Act liberalizes the rules applicable to S corporations so that an entity may more easily qualify as, and remain, a tax-favored S corporation. The most significant of these changes are:

- An increase in the number of eligible shareholders from 75 to 100.
- Permission to elect to treat all family members that own interests in an S corporation as a single shareholder for purposes of the new 100 shareholder test.
- Allowance of a waiver in the case of inadvertent invalid qualified subchapter S subsidiary elections and terminations.

## **New Anti-Expatriation Rules**

The Jobs Act contains an array of measures intended to discourage and penalize U.S. corporations and individual taxpayers that expatriate for the purpose of reducing their U.S. tax liability relating to their worldwide income. Thus, before a corporate taxpayer engages in a transaction that would result in moving part of its operations overseas, it should be aware that:

- U.S. corporations that place their operations under a new foreign parent (in a so-called “inversion” transaction) may be subject to regimes that either ignore the inversion for tax purposes or prevent the use of any tax attributes (such as losses or credits) from offsetting any gain recognized on the inversion.
- A 15% excise tax (which will rise to 20%) will be imposed on the value of certain stock-based compensation held by certain insiders (e.g., corporate officers) of inverted corporations.
- The liquidation of a U.S. holding corporation into a foreign parent will be treated as a taxable dividend, subject to a 30% withholding tax, to the extent of the U.S. corporation’s earnings and profits if the U.S. corporation has been in existence for less than 5 years prior to the liquidation.
- New rules expand the IRS’s authority to apply transfer pricing concepts to the reinsurance of U.S. risks in foreign jurisdictions.
- New rules modifying the tax treatment of U.S. citizens and long-term residents who expatriate. Chief among these rules are provisions that introduce a new, objective test for the determination of whether the individual will be subject to the expatriation tax regime and that impose new annual reporting requirements for expatriates who meet the new objective tests.

## **New Anti-Tax Shelter Rules**

The Jobs Act introduces the most sweeping anti-tax shelter rules to be seen in decades. Most of these changes relate to so-called reportable or listed transactions, but other significant changes have been introduced as well. The most important of these new rules are as follows:

### ***Reportable or Listed Transaction Rules***

- Material adviser with respect to any reportable or listed transaction must (1) timely file an information return including information regarding the transaction and (2) maintain a list identifying each person with respect to whom the adviser acted as a material adviser.
- The statute of limitations for listed transactions will be extended to one year following the earlier of either (1) the date the required information relating to the transaction is adequately provided or (2) the date the list maintenance rules relating to the transaction are satisfied by a material advisor.

- A new \$10,000 to \$200,000 penalty will be imposed for failure to disclose reportable/listed transactions. Additionally, a public entity assessed such a penalty must disclose the imposition of such a penalty in its reports to the Securities and Exchange Commission.
- An increased, 20% to 30% accuracy-related penalty will be assessed upon any underpayment attributable to a listed or reportable transaction. Further, the prior law's "reasonable cause" exception to such penalty has been tightened or eliminated, depending upon the circumstances, and a taxpayer may not rely upon a "disqualified opinion" or the opinion of a "disqualified tax adviser" in claiming such exception.
- The IRS may impose sanctions in the form of censure or monetary penalties upon tax practitioners involved in reportable transactions or upon their employers. The IRS may also be able to impose standards for written advice that has the potential for tax avoidance or evasion.
- Where a taxpayer timely files its tax return but fails to pay the full amount of tax due, the accrual of interest on the underpayment is generally suspended if the IRS does not furnish the taxpayer with a notice of its actual tax liability within the 18 months following the date on which the return was filed. The Jobs Act denies the benefit of this interest suspension rule in the case of any underpayment relating to either a listed transaction or a reportable transaction with a significant tax avoidance purpose (a so-called reportable avoidance transaction). In addition, new rules will disallow the deduction of any interest paid or accrued on underpayments of tax relating to undisclosed listed or reportable avoidance transactions.

### ***Tax Shelter Promoters***

- An increased, 50% penalty will be imposed on certain tax shelter promoters.
- The tax practitioner's duty of confidentiality will not be applicable to any communication involving any tax shelters, rather than merely corporate tax shelters, as was the case under prior law.

### ***Increased Penalty for Failure to Report an Interest in a Foreign Account.***

A penalty of up to \$10,000 will now be imposed for any taxpayer who fails to report an interest in a foreign account in Part III of Schedule B, without regard to willfulness. The penalty may be waived if the amount of the transaction or the balance of the foreign account was properly reported and there was reasonable cause for the failure to report the actual interest in the account. In addition, the prior-law penalty for willful behavior increases to \$100,000 (or significantly more, under some circumstances).

## **New Loss Limitation Rules**

### ***Limitation on Corporate Importation of Built-in Losses***

If “net built-in loss” property is transferred to a U.S. corporation in a tax-free reorganization or section 351 contribution from a transferor not subject to tax in the U.S., the basis of each property transferred is equal to its fair market value (i.e., whether it is below or above the basis). A “net built-in loss” is determined by comparing the aggregate basis of transferred properties to the properties’ aggregate fair market value. In addition, a similar rule applies if “net built-in loss” property is distributed from a foreign subsidiary to a U.S. parent in a section 332 liquidation.

### ***Limitation on Certain Partnership Built-in Loss Transfers and Imposition of Mandatory Basis Adjustments***

Under the Jobs Act, built-in loss with respect to property contributed to a partnership may be taken into account only by contributing partner and not by other partners. In addition, basis adjustment rules under section 743(b) are mandatory for transfers of partnership interests with a substantial built-in loss (i.e., a loss arising where the partnership’s adjusted basis in its property exceeds the fair market value by more than \$250,000). Similarly, a basis adjustment under section 734(b) is required for distributions of built-in loss property requiring a substantial basis reduction (i.e., a downward basis adjustment of more than \$250,000). Certain exceptions to these rules are available in the case of “securitization partnerships” and “electing investment partnerships.”

## **MORGAN LEWIS TAX GROUP CONTACTS**

Morgan Lewis’ Tax Group has significant experience working with both domestic and cross-border planning issues. If you have questions or concerns relating to the Jobs Act, please contact the Morgan Lewis lawyer with whom you regularly work or any of the following members of our Tax Group:

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