

Three Highlights of American Jobs Creation Act of 2004

H.R. 4520, the American Jobs Creation Act of 2004, was signed into law by President Bush on Friday, October 22, 2004. Legislation was needed to repeal the extraterritorial income ("ETI") exclusion that had been ruled an illegal export subsidy by the World Trade Organization and that had caused the European Union to begin imposing punitive tariffs against U.S. exports. This legislation phases out the ETI exclusion in 2005 and 2006 and replaces it with a new domestic manufacturing deduction. However, this legislation was not limited to repealing and replacing the ETI exclusion. It contains 193 separate tax provisions.

In This Issue, we focus on three highlights:

- [The Domestic Manufacturing Deduction](#)
- [Changes to the Treatment of Nonqualified Deferred Compensation](#)
- [A New Above-the-Line Deduction for Legal Fees and Costs in Civil Rights \(and Certain Other\) Litigation](#)

The Domestic Manufacturing Deduction

In order to provide an incentive for domestic manufacturing (and replace the ETI exclusion), effective in taxable years beginning on or after January 1, 2005, the legislation provides a new deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's "qualified production activities income." This deduction in effect lowers the effective tax rate on income derived from domestic manufacturing (and as explained below, certain other domestic business activities that would not generally be considered as manufacturing).

This deduction is phased in from 2005 through 2010. For taxable years beginning after 2009, the deduction is equal to 9% of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, or (2) taxable income (determined without regard to this provision) for the taxable year. For taxable years beginning in 2005 and 2006, the deduction is 3% and, for taxable years beginning in 2007, 2008 and 2009, the deduction is 6%.

In keeping with an intention to encourage U.S. employment, the deduction for a taxable year is limited to 50% of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year. The deduction is allowed for purposes

Contact Info

If you would like more information, please contact any of the McKenna Long & Aldridge attorneys with whom you regularly work. You may also contact:

Atlanta:

Tax:
William Joseph
404.527.8586
Russell Love
404.527.8160

Benefits:
Patricia Tate
404.527.8410
Jim Talerico
404.527.8449

Los Angeles:

Tax:
Dudley Lang
213.243.6144

of computing alternative minimum taxable income.

For domestic production activities of an S corporation, partnership, estate, trust or other pass-through entity (other than an agricultural or horticultural cooperative), the wage limitation is applied first at the entity level. The deduction is then generally determined at the shareholder, partner or similar level by taking into account at such level the proportionate share of qualified production activities income of the entity. For purposes of applying the wage limitation at the level of an S corporation shareholder, partner, or similar person, each person who is allocated qualified production activities income from a pass-through entity is treated as having been allocated wages from such entity in an amount that is equal to the lesser of:

1. such person's allocable share of wages, as determined under regulations; or
2. twice the appropriate deductible percentage of qualified production activities income that actually is allocated to such person for the taxable year.

Several new terms are added to the tax lexicon and new complexity is added as well:

Qualified Production Activities Income

"Qualified production activities income" is equal to domestic production gross receipts, reduced by the sum of:

1. the costs of goods sold that are allocable to such receipts;
2. other deductions, expenses, or losses that are directly allocable to such receipts; and
3. a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.

Guidance from Treasury will be needed regarding how expenses should be allocated between production and non-production receipts.

Domestic Production Gross Receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from:

1. any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States;
2. any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer;
3. any sale, exchange or other disposition electricity, natural

gas, or potable water produced by the taxpayer in the United States;

4. construction activities performed in the United States; or

5. engineering or architectural services performed in the United States for construction projects located in the United States.

Domestic production gross receipts do not include any gross receipts of the taxpayer that are derived from (1) the sale of food or beverages prepared by the taxpayer at a retail establishment, or (2) the transmission or distribution of electricity, natural gas, or potable water. In addition, domestic production gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed or rented by the taxpayer for use by any related person. While the deduction is dubbed a “manufacturing” deduction, this definition of domestic production gross receipts extends the benefit of the deduction well beyond typical manufacturing to cover production of natural gas, electricity or potable water, film production and professional services performed in connection with construction.

Qualifying Production Property

“Qualifying production property” generally includes any tangible personal property, computer software, or sound recordings.

Qualified Film

“Qualified film” includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50% or more of the total compensation relating to the production of such film (including compensation in the form of residuals and participations constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

Guidance will be required to clarify what activities constitute manufacturing or production. Often receipts cover manufactured property, services and intellectual property so guidance will be needed to clarify how to allocate receipts between the production and non-production activities. Further, taxpayers that are engaged in the integrated production and transmission of natural gas, electricity or potable water will need to be able to allocate receipts (and expenses) between production and transmission.

This deduction, while welcome, clearly will not be simple for taxpayers to apply or for the IRS to administer.

[↗ Back to top](#)

Changes to the Treatment of Nonqualified Deferred Compensation

The legislation provides new requirements that will need to be satisfied beginning in 2005 in order to receive the benefit of deferral of tax on nonqualified deferred compensation. Many companies have put in place nonqualified deferred compensation plans that are intended to allow employees to defer taxation of compensation by deferring the receipt of such compensation until specified times or events. It will be imperative to review and potentially amend all plans that are covered by this provision.

The new requirements for nonqualified deferred compensation will be effective for amounts deferred in taxable years beginning on or after January 1, 2005. If these requirements are not satisfied, the consequences can be harsh. The participant must include the deferred compensation in income when vested. In addition, the participant would be subject to a 20% penalty on the amount required to be included in income plus interest at the underpayment rate plus 1%.

The new requirements address when distributions may be made from the plan and when a deferral election must be made.

The plan must provide that distributions of deferred compensation may not be made before:

- separation from service;
- the date the participant becomes disabled;
- death;
- a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation;
- to the extent provided in regulations, a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or
- the occurrence of an unforeseeable emergency.

For key employees of a public company, distributions may not be made on account of separation from service until 6 months thereafter. Further, the plan must not permit acceleration of distributions except as permitted under regulations.

Generally, a deferral election will be required to be made before the close of the taxable year preceding the taxable year in which the services are performed. For the first year in which an employee becomes eligible to participate in the plan, the election may be made within 30 days after the date on which the employee first becomes eligible. In the case of any performance-based compensation for services performed over a period of at least 12 months, such election may be made no later than 6 months before the end of the period. Under the provision, a plan may allow changes in the time and form of distributions subject to certain requirements.

The provision also restricts the use of foreign trusts to hold assets set aside for the payment of deferred compensation. Any such assets will be treated as paid over to employees (unless substantially all of the employee's services are performed in the foreign jurisdiction) and thus will be includible in the employee's income. In addition, income is includible in the employee's income if assets become restricted to use for the payment of deferred compensation upon a change in the employer's financial health.

Grandfather rules are provided pursuant to which these provisions would not apply to amounts deferred before January 1, 2005. However, amounts deferred before

2005 would become subject to the rules if the plan is materially modified after October 3, 2004.

Existing nonqualified deferred compensation plans will need to be reviewed and amended to comply with these new requirements. The provision directs the IRS to issue guidance within 60 days following enactment to provide a period during which plans can be amended to comply with these requirements and or permit termination of outstanding deferral elections. Amendments made pursuant to this guidance will not be treated as a material modification that would otherwise trigger tax on amounts deferred prior to 2005. It will be prudent to wait until such guidance is forthcoming before amending plans to avoid a material modification. However, once the guidance comes out, it may be necessary to amend plans and permit employees to make deferral elections for 2005 before the end of 2004 (unless the guidance also extends the time for 2005 deferral elections).

An important issue with respect to which guidance will be needed is the definition of nonqualified deferred compensation. The Conference Report indicated that nonqualified deferred compensation is not intended to include stock options providing an exercise price at least equal to the fair market value of the stock on the date of grant. Unanswered is whether this provision therefore is intended to apply to discounted options, and if so, how. In addition, guidance will be needed to address the application of these rules to other forms of equity-based compensation such as stock appreciation rights and phantom stock.

[↗ Back to top](#)

A New Above-the-Line Deduction for Legal Fees and Costs in Civil Rights (and Certain Other) Litigation

The new legislation contains a provision that provides a new above-the line deduction for the claimant's legal fees and costs in civil rights (and certain other) litigation.

Damages not involving physical injuries are generally included in the plaintiff's gross income. Under the law in effect prior to enactment of this legislation, the related expenses to recover such damages, including attorneys' fees, are generally deductible as expenses for the production of income, that for individual taxpayers, are subject to the 2% floor on miscellaneous itemized deductions. Thus, such expenses are deductible only to the extent the taxpayer's total miscellaneous itemized deductions exceed 2% of adjusted gross income. Any amount allowable as a deduction is subject to further reduction under the overall limitation of itemized deductions if the taxpayer's adjusted gross income exceeds a threshold amount. In addition, and most notably, for purposes of the alternative minimum tax, no deduction is allowed for any miscellaneous itemized deduction. Many taxpayers receiving large recoveries in civil rights actions and paying a large percentage of these recoveries as contingent fees would become subject to the alternative minimum tax and in effect become taxable on the portion of their recovery that is paid as attorneys' fees. (Thus, this amount is subject to double taxation - to the claimant and to the attorney.)

A majority of Circuits (the Federal, First, Second, Third, Fourth, Seventh, Eighth, Ninth and Tenth) have held that the entire recovery, including the portion paid directly to the claimant's attorney is includible in the claimant's income and is allowable only as a miscellaneous itemized deduction (which subjects the claimant to

the 2% floor, reduction of miscellaneous itemized deductions and alternative minimum tax consequences).

A minority of Circuits (the Fifth, Sixth and Eleventh) have held that the portion of the recovery that is paid directly to the attorney is not income to the claimant, holding that the claimant has no claim of right to that portion of the recovery. The Supreme Court has granted certiorari in two cases involving this issue (*Banaitis v. Commissioner*, 340 F.3d 1034 (9th Cir. 2003); *Commissioner v. Banks*, 345 F.3d 373 (6th Cir. 2003).)

The legislation provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination, certain claims against the Federal Government, or a private cause of action under the Medicare Secondary Payer statute. The amount that may be deducted above the line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim. By providing this deduction above the line, the deduction is no longer subject to the 2% floor, reduction of miscellaneous itemized deductions and alternative minimum tax consequences discussed above.

Under this provision, "unlawful discrimination" means an act that is unlawful under certain provisions of the following:

- the Civil Rights Act of 1991;
- the Congressional Accountability Act of 1995;
- the National Labor Relations Act; the Fair Labor Standards Act of 1938;
- the Age Discrimination in Employment Act of 1967;
- the Rehabilitation Act of 1973;
- the Employee Retirement Income Security Act of 1974;
- the Education Amendments of 1972;
- the Employee Polygraph Protection Act of 1988;
- the Worker Adjustment and Retraining Notification Act;
- the Family and Medical Leave Act of 1993;
- chapter 43 of Title 38 of the United States Code;
- the Revised Statutes (42 U.S.C. secs. 1981, 1983 or 1985);
- the Civil Rights Act of 1964;
- the Fair Housing Act;
- the Americans with Disabilities Act of 1990;
- any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law; or
- any provision of Federal, State or local law, or common law claims permitted under Federal, State, or local law providing for the enforcement of civil rights or regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

The provision applies to fees and costs paid after the date of enactment (October 22, 2004) with respect to any judgment or settlement occurring after such date.

At least with respect to the types of claims to which this new provision applies, plaintiffs will not be taxed on attorneys' fees and costs that they do not themselves receive. This will facilitate settlements and acceptance of smaller recoveries (as well-advised plaintiffs must consider their after-tax recovery). For other types of claims, resolution of this tax issue will come from the Supreme Court.

[↗ Back to top](#)

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