

Washington Tax Report

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On October 22, 2004, the President signed into law the “American Jobs Creation Act of 2004.” Although the centerpiece of the Act is the gradual repeal of the Extraterritorial Income (ETI) exclusion on qualifying foreign trade income, which was ruled a prohibited export subsidy by the World Trade Organization in 2002, and its replacement by a deduction for domestic qualified production activities income, the Act also contains a myriad of other tax changes including changes affecting:

- U. S. businesses and corporations
- International businesses
- S corporations
- Partnerships
- Individuals
- Deferred Compensation

This *Washington Tax Report* does not describe all of the countless provisions of the new law; only those provisions we believe may be of significance to our clients. After reviewing this Report, we encourage you to contact your BDO Seidman, LLP or BDO Seidman alliance firm client service professional concerning provisions that may affect you or your business.

Income Tax Changes Affecting U. S. Businesses and Corporations

Income Attributable to United States Production Activities

Old Law

There is no provision that reduces the income tax on taxable income attributable to domestic production activities.

New Law

A deduction equal to 3 percent of “qualified production activities income” is provided for taxable years beginning in 2005 and 2006, 6 percent for taxable years beginning in 2007, 2008, and 2009, and 9 percent for taxable years beginning after 2009. “Qualified production activities income” is equal to “domestic production gross receipts” less the costs of goods sold allocable to such receipts and other deductions, expenses, or losses directly and indirectly allocable to such receipts. In general, “domestic production gross receipts” are gross receipts of a taxpayer derived from (1) the sale or lease of “qualifying production property” manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States, (2) the sale or lease of “qualified film” produced by the taxpayer, (3) the sale of 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. “Qualified production property” generally includes tangible personal property, computer software, or sound recordings. “Qualified film” includes any motion picture film or videotape if 50 percent or more of the total compensation relating to its production is for services performed in the United States.

The tax deduction for qualified production activities income is limited to 50 percent of the wages paid by the taxpayer in the calendar year that ends with or within the taxpayer’s taxable year and may not exceed taxable income computed without regard to this deduction..

Owners or beneficiaries of passthrough entities (partnerships, S corporations, trusts, and estates) are also entitled to a deduction on their proportionate share of the qualified production activities income of the passthrough entity. The wage limitation is determined at the entity level.

Effective Date Comments & Observations

Effective for tax years beginning after December 31, 2004.

This deduction is intended to replace the export subsidy provided by the “FSC Repeal and Extraterritorial Income Exclusion Act of 2000,” which was ruled illegal in 2002 by the World Trade Organization. During the period before the complete phase-out of the Extraterritorial Income (ETI) exclusion, qualifying taxpayers are eligible for both the Production Activities Income deduction and the ETI exclusion. Extensive Treasury Department regulations should be expected to administer this new provision.

Expense Allowance for Small Businesses

Old Law

For taxable years beginning in 2003, 2004, and 2005 the maximum cost of tangible personal property that businesses may elect to deduct in the year the property is placed in service is \$100,000 and the cost of qualifying property after which the expense allowance begins to phase-out is \$400,000. For taxable years beginning after 2005, the maximum expense allowance returns to the pre-2003 amount of \$25,000 and the \$400,000 phase-out amount returns to the pre-2003 amount of \$200,000. For these years, these increased amounts are indexed for inflation. Property qualifying for this deduction for these years also includes off-the-shelf computer software.

New Law

The increased \$100,000 and \$400,000 amounts that apply for taxable years beginning in 2003, 2004, and 2005 are extended to taxable years beginning in 2006 and 2007 and are indexed for inflation. Off-the shelf computer software is also included as property qualifying for the expense allowance for these years.

Effective Date Comments & Observations

Effective on the date of enactment for taxable years beginning in 2006 and 2007.

Note that although the increased expense allowance was extended, the 30 percent and 50 percent first-year bonus depreciation that applies to qualifying property acquired or constructed on or before December 31, 2004 was not extended.

Depreciation of Sport Utility Vehicles

Old Law

SUVs with a gross vehicle weight rating in excess of 6,000 pounds are not “passenger automobiles” and, accordingly, are not subject to the depreciation limitation on passenger automobiles. This depreciation limitation encompasses the expense allowance, the first-year bonus depreciation, and regular depreciation.

New Law

SUVs rated at 14,000 pounds or less are subject to a maximum expense allowance of \$25,000.

Effective Date Comments & Observations

Effective for SUVs placed in service after the date of enactment, October 22, 2004.

Under the Act, an SUV having a gross vehicle weight rating in excess of 6,000 pounds but of 14,000 pounds or less is not subject to the passenger automobile depreciation limitation, but is subject to

the \$25,000 expense allowance limitation. If acquired and placed in service in 2004, the SUV is eligible for the first-year bonus depreciation, which expires after 2004.

Recovery Period for Depreciation of Certain Leasehold and Restaurant Improvements

Old Law

As is the case with all nonresidential real property, improvements made to leased nonresidential real property by the lessor or lessee are depreciated using the straight-line method over 39 years, regardless of the length of the lease. Similarly, improvements made to real property that is devoted to the preparation of, and seating for, on-premises consumption of prepared meals are depreciated using the straight-line method over 39 years.

New Law

Improvements made by the lessor or lessee to the interior portion of leased nonresidential real property occupied exclusively by the lessee that are placed in service more than three years after the building was first placed in service and before January 1, 2006 are depreciated using the straight-line method over 15 years.

Improvements made to a building more than 50 percent of the square footage of which is devoted to the preparation of, and seating for, in-premises consumption of prepared meals that are placed in service more than three years after the building was first placed in service and before January 1, 2006 are depreciated using the straight-line method over 15 years.

Effective Date Comments & Observations

Effective for property placed in service after the date of enactment, October 22, 2004, and before January 1, 2006.

Qualified restaurant improvements constructed and placed in service after October 22, 2004 and before January 1, 2005, is now eligible for the additional first-year bonus depreciation as a result of its now 15-year recovery period.

First-Year Bonus Depreciation for Non-Commercial Aircraft

Old Law

In order to qualify for the 30 percent or 50 percent additional first-year bonus depreciation aircraft not used in the trade or business of transporting persons or property is required to be placed in service before January 1, 2005. Such aircraft does not qualify for the extended one-year placed in service date allowed to transportation property used in the trade or business of transporting persons or property.

New Law

To be eligible for the additional first-year bonus depreciation, the extended one-year placed in service date also applies to aircraft not used in the trade or business of transporting persons or property.

Effective Date Comments & Observations

Effective on the date of enactment for property placed in service during calendar year 2005.

Start-Up and Organizational Expenses

Old Law

Taxpayers may elect to amortize start-up expenses (expenses that would be deductible if the business had begun) and organizational expenses (expenses that are incident to the creation of a corporation or organization of a partnership) over a period of not less than 60 months.

New Law

Taxpayers may elect to deduct \$5,000 of start-up expenses and \$5,000 of organizational expenditures in the taxable year in which the business begins if the cumulative amount of start-up or organizational expenses does not exceed \$50,000. The \$5,000 deductible amounts are reduced by the cumulative amount that the start-up expenses or organizational expenses exceed \$50,000, respectively. Start-up and

organizational expenses that are not deducted in the year the business begins are amortized over a 15-year period.

Effective Date Comments & Observations

Effective for start-up and organizational expenses incurred after October 22, 2004.

Start-up or organizational expenses incurred before or after the date of enactment are considered for purposes of determining whether the \$50,000 cumulative amount has been exceeded.

Start-up or organizational expenses incurred in 2004 before and after October 22 will require two elections, an election under the old law and an election under the new law.

Reporting of Taxable Mergers and Acquisitions

Old Law

No provision exists that requires an information return be filed where a shareholder of an acquired corporation is taxed upon an acquisition of the stock or assets of the acquired corporation other than in an acquisition where the shareholder receives cash.

New Law

An information return containing specific information is required to be filed by an acquiring corporation (or the acquired corporation if so prescribed by the Treasury Department) or transfer agent in all acquisitions where gain or loss is recognized by shareholders of the acquired corporation. A written statement containing specific information also is required to be provided to affected shareholders.

Effective Date Comments & Observations

Effective for acquisitions after October 22, 2004.

Transfer of Built-In Losses

Old Law

In a tax-free transfer of property to a corporation in exchange for stock of the transferee corporation, the basis of the stock received by the transferor is the basis to the transferor of the property transferred prior to the transfer. The transferee's basis in the property received is also the basis of such property to the transferor prior to the transfer.

New Law

In a tax-free transfer of property to a corporation, if the aggregate basis of the property transferred exceeds the aggregate fair market value of such property the transferee's aggregate basis in the property received is limited to the property's fair market value. Upon an election by both the transferor and transferee, in lieu of the transferee taking a basis in the property received equal to the property's fair market value, the basis of the stock received in the transaction can be limited to fair market value.

Effective Date Comments & Observations

Effective for transactions after October 22, 2004.

The purpose of this provision appears to be to preclude a duplication of a loss with respect to property that occurred prior to a transfer of the property to a corporation (built-in loss) at both the transferor shareholder level and the transferee corporate level. This potential for loss duplication occurs when, as under current law, the basis of the property transferred to a corporation, which is higher than the property's fair market value, is preserved in both the stock received by a shareholder and in the property transferred to the corporation. Apparently, Congress was not concerned with the duplication of built-in gain, which occurs when the fair market value of property transferred to a corporation is greater than its basis.

Exception to Nonrecognition of Gain in Certain Corporate Reorganizations

Old Law

In an otherwise tax-free corporate reorganization as defined under Section 368(a)(1)(D) of the Internal Revenue Code, gain is recognized to the corporation transferring its assets (transferor corporation) to the extent that the amount of liabilities of the transferor corporation assumed by the transferee corporation or to which the assets transferred are subject is in excess of the aggregate basis of the assets transferred. An acquisitive corporate reorganization under Section 368(a)(1)(D) occurs where substantially all of the assets of a corporation are transferred to another corporation and the shareholders of the transferor corporation own immediately after the transfer stock of the transferee corporation equal to at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.

New Law

In an acquisitive corporate reorganization under Section 368(a)(1)(D) gain is not recognized to the transferor corporation where the amount of its liabilities assumed by the transferee corporation or to which its assets transferred are subject is in excess of the bases of its assets transferred.

Effective Date Comments & Observations

Effective for transactions on or after October 22, 2004.

The elimination of this gain recognition rule in the case of acquisitive corporate reorganization as defined under Section 368(a)(1)(D) eliminates a trap for the unwary that existed where an acquisitive reorganization as defined under another provision of the Code is also defined under Section 368(a)(1)(D) or where under general principles of tax law the steps of a transaction are integrated and treated as a reorganization under Section 368(a)(1)(D). The new law does not apply to reorganiza-

tion under Section 368(a)(1)(D) that is part of a transaction in which a single corporation is separated

Penalty for Failure to Pay Estimated Income Tax by Corporations on Stock Sales Treated as Asset Sales

Old Law

It is questionable whether the exemption from penalty for failure to pay estimated income tax on stock sales elected to be treated as asset sales applies to the special election available in the case of a stock sale of an S corporation or a member of an affiliated group of corporations

New Law

The exemption from penalty for failure to pay estimated tax does not apply to stock sales of S corporations or members of an affiliated group.

Effective Date Comments & Observations

Effective for stock sales occurring after October 22, 2004.

The Conference Report to the legislation states that no inference is intended as to present law.

Tax Rates for Controlled Group of Corporations

Old Law

The taxable income of component members of a controlled group of corporations (a brother-sister controlled group or a parent-subsidiary controlled group) are combined in determining each member's income tax rate bracket. A brother-sister controlled group consists of two or more corporations if five or fewer individuals, estates, or trusts own directly or indirectly stock possessing (1) at least 80 percent of the combined voting power of all classes of stock entitled to vote and at least 80 percent of the total value of all stock, and (2) 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 the stock ownership is identical with respect to each corporation.

New Law

Solely for purposes of determining the tax rate bracket of each member of a brother-sister controlled group of corporations, a brother-sister controlled group consists of two or more corporations if five or fewer individuals, estates, or trusts own directly or indirectly stock possessing 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 the stock ownership is identical with respect to each corporation.

**Effective Date
Comments & Observations**

Effective for tax years beginning after October 22, 2004.

Limitation on Deductions for Certain Employer-Provided Expenses of Entertaining Covered Employees

Old Law

Generally, a taxpayer cannot take deductions for entertainment, recreation, or amusement related expenses unless the taxpayer can establish that the expenses were directly related to or associated with the active conduct of its trade or business. However, under one exception, the deduction disallowance rule does not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation or wages to an employee.

New Law

The compensation and wage exception is limited where the recipient is a “specified individual,” defined as an individual subject to the requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer, or who would be “specified individual” if the taxpayer

were an issuer of equity securities subject to those requirements. These individuals would include officers, directors, and 10% or greater owners. A taxpayer would only be allowed a deduction for the related entertainment, recreation, or amusement expense equal to the lesser of the actual expenses incurred or the amount included in the specified individual’s compensation or wage.

**Effective Date
Comments & Observations**

Effective for expenses incurred after October 22, 2004.

This rule is primarily directed at overriding *Sutherland Lumber-Southwest, Inc. v. Commissioner* and the IRS’ acquiescence to this case. The Tax Court allowed the taxpayer to deduct all the expenses associated with operating the business airplane to fly officers on vacations even though they only recognized a small portion of this amount as compensation.

Income Tax Changes Affecting International Businesses

Repeal of Exclusion for Extraterritorial Income

Old Law

Under the extraterritorial income ("ETI") regime, an exclusion from gross income applies with respect to "extraterritorial income," which is a taxpayer's gross income attributable to "foreign trading gross receipts." This income is eligible for the exclusion to the extent that it is "qualifying foreign trade income." Qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of: (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction; (2) 15 percent of the "foreign trade income" derived by the taxpayer from the transaction; or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction.

Foreign trading gross receipts are gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes take place outside of the United States. Qualifying foreign trade property generally is property manufactured, produced, grown, or extracted within or outside the United States that is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use, consumption, or disposition outside the United States. No more than 50 percent of the fair market value of such property can be attributable to the sum of: (1) the fair market value of articles manufactured outside the United States; and (2) the direct costs of labor performed outside the United States. With respect to property that is manufactured outside the United States, certain rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers.

New law

The Act repeals the ETI exclusion. For transactions prior to 2005, taxpayers

retain 100 percent of their ETI benefits. For transactions after 2004 there is a phase-out of the benefit. The Act provides taxpayers with 80 percent of their otherwise-applicable ETI benefits for transactions during 2005 and 60 percent of their otherwise-applicable ETI benefits for transactions during 2006. However, the Act provides that the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract between the taxpayer and an unrelated person and such contract is in effect on September 17, 2003 and at all times thereafter.

In addition, foreign corporations that elected to be treated for all Federal tax purposes as domestic corporations in order to facilitate the claiming of ETI benefits are allowed to revoke such elections within one year of the date that the Act comes into law without recognition of gain or loss, subject to anti-abuse rules.

Effective Date Comments & Observations

**Effective for transactions after
December 31, 2004.**

Repatriation of Controlled Foreign Corporation Earnings

Old Law

Under current law, the earnings of a foreign corporation are fully taxable in the U.S. as ordinary income when repatriated to the U.S. shareholder as a dividend. If the taxpayer is a domestic corporation that owns 10 percent or more of the stock in the foreign corporation, they are eligible for an indirect foreign tax credit for the underlying taxes paid by the foreign entity under Section 902. A credit is also available for direct foreign income taxes paid to a foreign jurisdiction such as withholding taxes. Dividends received from foreign corporations by individuals or pass-through entities are eligible for a reduced rate of tax at 15 percent if the dividend is a qualifying dividend paid from a country in which the U.S. has a comprehensive tax treaty.

New Law

Conference Agreement

The Act provides for a limited one time election for U.S. corporations to repatriate the unremitted earnings of its controlled foreign corporation for which it is a U.S. shareholder and receive an 85 percent dividends received deduction (DRD). The provisions (including limitations) are provided in new Code Section 965.

Limitations:

Cash Dividends

Repatriations of dividends are only eligible for the DRD to the extent that they are cash dividends. The definition of "cash dividend" generally includes cash amounts included in gross income as a dividend. The law is interpreted to include cash payments made in redemptions such as Section 302 and Section 304 type of transactions. Cash dividends also include a cash distribution from a CFC that was excluded from income as previously taxed income to the extent of Subpart F inclusions as a result of election-year cash dividend received by one CFC from another. The rule specifically would preclude non-cash dividends such as Section 956 inclusions, or amounts included in income under Section 78, Section 367, and Section 1248. However, inclusions under these sections will be eligible for the 85 percent DRD in a Section 332 liquidation in which the U.S. shareholder receives cash in the liquidation.

It should be noted that a CFC cannot borrow from its U.S. shareholder, or other U.S. affiliate, in order to finance a cash payment of a deductible dividend.

Extraordinary Dividends

The Act also requires that the dividends be "extraordinary" in order to be eligible for the 85 percent DRD. A dividend is considered to be extraordinary to the extent it is received by the U.S. shareholder in the election year and is in excess over a base period average. The base period average is computed by averaging annual taxable dividends of the CFC, including Section 956 inclusions and PTI distribu-

tions, for a historical base period. The base period is made up of the five preceding taxable years ending on or before June 30, 2003. The taxpayer is required to discard the highest and lowest annual amounts in determining the base period amount. If a taxpayer does not have the requisite history to comprise the 5-year base period amount, it is to use all of the tax years that it has been in existence prior to June 30, 2003. Repatriated amounts would be determined by reference to the amounts reported on the taxpayer's annual tax return. Special rules will apply in determining the base period where a taxpayer joins or leaves consolidated groups.

Domestic Reinvestment Plan

In order to qualify for the deduction, the dividend received by the U.S. shareholder must be invested in the U.S. pursuant to a domestic reinvestment plan. The domestic reinvestment plan must be approved and certified by the taxpayer's CEO, president, or comparable official before the dividend is paid, and subsequently approved by the Board of Directors, Management Committee, Executive Committee or similar body. The plan must provide for the reinvestment of the amount in the United States for purposes such as investment in worker hiring and training, infrastructure, research & development, capital investments, or the financial stabilization of the corporation for the purposes of job creation or retention.

ABP 23 Limitation

A further limitation on the ability to take the deduction is imposed on companies to the extent of their financial statement disclosure with respect to unremitted earnings of the foreign subsidiaries. The total dividend eligible for the deduction is limited to U.S. \$500 million unless the taxpayer's financial statements specify that an amount of unremitted earnings exist outside of the U.S. and are permanently reinvested. The amount, if in excess of U.S. \$500 million, must have been reported on the taxpayer's most recent financial statements filed with the SEC on or before June 30, 2003.

Foreign Tax Credit Limits

A foreign tax credit (or deduction) is generally not allowed for foreign taxes attributable to the deductible portion of any extraordinary dividend that qualifies for the deduction. The taxpayer may specifically identify which dividends generate the 85 percent dividends received deduction and which dividends do not. If the taxpayer does not specifically identify which dividends qualify, a pro rata amount of foreign tax credits will be disallowed with respect to every dividend repatriated during the taxable year. The foreign source income of the taxpayer will be directly reduced by the amount of the deduction. The Act also provides that no deduction will be allowed for expenses properly allocated and apportioned to the deductible portion of a dividend.

Effective Date Comments & Observations

At the taxpayer's election, the deduction is available for dividends received either during the taxpayer's last tax year beginning before October 22, 2004, or during the taxpayer's first year which begins during the one-year period beginning on October 22, 2004.

There will be many factors that a domestic corporation will need to consider before they make the election to take the 85 percent DRD with respect to foreign dividends received from their CFC's. In order to make that decision, there are several cost/benefits that need to be assessed before making the election. For instance, the foreign tax credit could be impacted based on the mix (i.e. high taxed vs. low taxed) of the corporation's foreign subsidiary earnings and profits pools. Local country CFC's may have to borrow locally to finance the payment of the dividend. This may have both a cost and a benefit as the interest will reduce local country taxes. NOL's and General Business Credits cannot be used to reduce tax on the dividend and certain expenses associated with the dividend may be completely disallowed. Also local country laws will need to be considered to determine if a dividend can legally be

paid. Taxpayers should also consider their APB 23 positions when making statements relating to their reinvestment plans. Lastly, given all of the potential issues associated with making the election, taxpayers should consider alternative repatriation strategies prior to making the election.

Cash Method for OID, Interest, and Other Non Effectively Connected Foreign Source Income

Old Law

Generally puts a taxpayer on the cash method of accounting with respect to amounts owed to a related foreign person. An exception is provided where the related foreign person is a controlled foreign corporation ("CFC"), foreign personal holding company ("FPHC"), or passive foreign investment company ("PFIC"), in which case a taxpayer can deduct accrued amounts as of the day in which the amounts are includible in the income of the CFC, FPHC, or PFIC, regardless of whether or not such amounts are currently included in the income of the U.S. owners.

New Law

The new law provides that an accrued but unpaid amount due from a U.S. taxpayer to a related CFC or PFIC (FPHC's provisions are repealed) is not deductible until a corresponding amount is included in the gross income of a U.S. person who owns the stock (directly or through a foreign entity) in the CFC or PFIC. Amounts that have accrued, but are not allowable as a deduction will be allowed as a deduction when the amounts are paid.

The new law authorizes the Treasury Secretary to issue regulations to provide for an exception for certain payments occurring within a short period after accrual and arising from a transaction entered into by the payor in the ordinary course of business in which the payor is predominately engaged.

The provision applies to original issue discount, interest, and amounts other than

interest that are non-effectively connected foreign source income of a related foreign person.

Effective Date

Comments & Observations

Effective for payments accrued on or after October 22, 2004.

Foreign Tax Credit Carryforward and Carryback

Old Law

Under the old law, the amount of creditable taxes paid or accrued (or deemed paid) in any tax year which exceeds the foreign tax credit limitation could be carried back to the two immediately preceding tax years applied first to the earliest tax year; and any carryforward amount generated that was not carried back could be carried forward five years in chronological order.

New Law

Under the new law, the amount of creditable taxes paid or accrued (or deemed paid) in any tax year that exceeds the foreign tax credit limitation can only be carried back to the immediately preceding tax year; and any carryforward amount generated that is not carried back can be carried forward ten years in chronological order.

Effective Date

Comments & Observations

The ten-year carryforward period for excess foreign taxes is effective for any tax year ending after October 22, 2004. Thus, the extension of the carryforward period will apply to any carryforward amounts that extends into tax years ending after October 22, 2004, but that do not expire in the current tax year.

The one-year carryback period of excess foreign taxes will be effective for tax years beginning after October 22, 2004.

Reduction of Foreign Tax Credit Baskets

Old Law

The foreign tax credit limitation is calculated separately for the nine different baskets of foreign source income listed below:

- Passive income
- High withholding tax interest
- Financial services income
- Shipping Income
- Certain dividends from noncontrolled section 902 corporations
- Certain dividends from a DISC or former DISC
- Taxable Income attributable to foreign trade income
- Certain distributions from a FSC or former FSC
- Income other than described above (general category income)

New Law

The number of baskets will be reduced to the following two:

- Passive category income
- General category income

The new passive category income includes the old passive basket, as well as dividends from a DISC, distributions from a FSC and taxable income attributable to foreign trade income. Income from financial services also are included in the passive category unless earned by a member of a financial services group or any other person that is predominately engaged in the active conduct of a banking, insurance, financing or similar business. All other income is included in the new general category.

Effective Date

Comments & Observations

The new baskets apply for tax years beginning after December 31, 2006.

Foreign taxes carried forward to a tax year ending on or after December 31, 2006 will be assigned to one of the two new basket as if the new rules were in effect when the foreign taxes were paid or accrued. Treasury is authorized to issue new regulations to allocate taxes carried back from a post-effective year to a pre-effective year.

Interest Expense Allocation

Old Law

The calculation of the foreign tax credit limitation requires a taxpayer to determine how much of its U.S. taxable income is attributable to foreign sources. Accordingly, one of the deductions that must be allocated is the taxpayer's interest expense (regardless of how the loan proceeds were utilized). This calculation is done for all members of the affiliated group as if they were a single corporation and the allocation made based upon relative asset basis rather than gross income. The shares held in foreign subsidiaries is taken into account rather than the assets of those subsidiaries

New Law

A one-time election allows the taxpayer to allocate and apportion the interest expense of the domestic members of a worldwide affiliated group on a worldwide group basis (as if the worldwide group were a single corporation). Thus, the asset ratio employs a look-through to include the assets of the foreign subsidiaries. Under this election, third party interest expense incurred by the worldwide group would be allocated to the foreign source income of the U.S. members in an amount equal to the excess (if any) of: (1) the worldwide group's third party interest expense multiplied by the ratio of the total foreign assets over the total worldwide assets of the worldwide group, over (2) the third party interest expense incurred by foreign members of the worldwide 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. Note that this calculation is only for determination of the foreign tax credit limitation and does not entitle any of the foreign subsidiaries' interest expense to be deductible for U.S. tax purposes.

Further rules apply for financial institutions.

Effective Date

Comments & Observations

Effective for tax years beginning after December 31, 2008.

Translation of Foreign Taxes

Old Law

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.

New Law

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the new law provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayers's functional currency. Any election under the new law applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The law authorizes the Secretary to issue regulations that apply the election to foreign income taxes attributable to a qualified business unit.

Effective Date Comments & Observations

Effective with respect to taxable years beginning after December 31, 2004.

Equal Treatment for Interest Paid by Foreign Partnerships and Foreign Corporations

Old Law

As a general rule, interest income from bonds, notes or other interest-bearing obligations of non-corporate U.S. residents or domestic corporations is treated as U.S.-source income. Interest on obligations of foreign corporations and foreign partnerships is generally treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States. Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the rules above, with respect to a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).

New Law

Interest paid by foreign partnerships is treated similar to the treatment of interest paid by foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. The law applies only to foreign partnerships that are predominantly engaged in the active conduct of a trade or business outside the United States.

Effective Date Comments & Observations

Effective for taxable years beginning after December 31, 2003.

Prohibition on Nonrecognition of Gain through Complete Liquidation of Holding Company

Old Law

Dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are generally subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent. The 30-percent withholding tax may be reduced pursuant to an income tax treaty.

U.S. withholding tax is generally not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. Regulations under section 367(e) provide that the Commissioner may require a domestic liquidating corporation to recognize gain on distribution in liquidation made to a foreign corporation if a principal purpose of the liquidation is the avoidance of U.S. tax.

New Law

The law treats any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation as a dividend, provided that the U.S. holding company was in existence for less than five years.

Effective Date Comments & Observations

Effective for distributions occurring on or after October 22, 2004.

Recharacterization of Overall Domestic Loss

Old Law

A taxpayer's foreign source losses generally can offset U.S. source income. If a taxpayer has previous foreign losses, they must be recaptured by foreign source income before a foreign tax credit is allowable. Likewise, U.S. source losses can be used to reduce foreign source income, which

impacts the amount of the foreign tax credit. Domestic losses, however, are not recaptured and thus can permanently reduce foreign source income and the ability to use foreign tax credits.

New Law

If a taxpayer has a foreign tax credit limitation based upon domestic losses, a portion of the succeeding years' U.S. source income is recharacterized to foreign source income in an amount equal to the lesser of (1) the amount of the previous uncharacterized overall domestic losses, and (2) 50 percent of the taxpayer's U.S. source income for such succeeding year.

Effective Date Comments & Observations

For domestic losses incurred in tax years beginning after December 31, 2006.

Look-Through Rules for Dividends From Noncontrolled Section 902 Corporations

Old Law

Dividends paid by a company in which a taxpayer owns at least 10 percent and which is not a controlled foreign corporation (a "10/50 company") are subject to special foreign tax credit limitation rules. Dividends paid out of pre-2003 earnings and profits (E&P) are subject to a separate limitation calculation for all 10/50 companies that are not Passive Foreign Investment Companies (PFIC's). A separate limitation applies for each 10/50 company that is a PFIC. Dividends paid out of post 2002 E&P are separated into the different foreign tax credit limitation baskets based on the ratio of the 10/50 company's E&P in each category compared to the total (the "look-through approach").

New Law

The look-through approach will now be applied to all dividends paid by a 10/50 corporation that is not a PFIC. The year in which the E&P was accumulated is no longer relevant. To the extent that an allocation to other baskets cannot be sub-

stantiated, the dividend will be treated as passive income.

Effective Date Comments & Observations

Tax years beginning after December 31, 2002.

Attribution of Stock Ownership Through Partnerships to Apply in Determining Section 902 and Section 960 Credits

Old Law

Under the old law, the Code did not specifically address whether or not a domestic corporation was entitled to claim a foreign tax credit for foreign taxes deemed paid under IRC 902 and 960 when the stock of foreign corporation is held through a partnership.

New Law

The new law follows the IRS' view in Rev. Rul. 71-141, 1971-1 C.B. 211, and thus clarifies that a domestic corporation is entitled to claim a foreign tax credit for foreign taxes deemed paid under IRC 902 and 960, by a foreign corporation owned through either a domestic or foreign partnership. The partnership must own at least 10 percent of the foreign corporations voting stock.

Additionally, the provision clarifies that individuals, estate and trust beneficiaries, and corporate partners are permitted to claim a direct foreign tax credit with respect to their proportionate share of foreign taxes paid or accrued by the partnership.

Effective Date Comments & Observations

Tax years beginning after October 22, 2004.

Foreign Tax Credits Under Alternative Minimum Tax (AMT)

Old Law

Under the old law taxpayers were subject to an alternative minimum tax (AMT), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit. The AMT foreign tax credit for any taxable year generally could not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit was limited to 90 percent of AMT computed without any AMT net operating loss deduction and the AMT foreign tax credit.

New Law

Under the new law the AMT foreign tax credit is no longer limited to 90 percent.

Effective Date Comments & Observations

Tax years beginning after December 31, 2004.

Minimum Holding Period for Foreign Tax Credit With Respect to Withholding Tax on Income Other Than Dividends

Old Law

Present law denies a U.S. shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a Regulated Investment Company ("RIC") if the shareholder has not held the stock for more than 15 days (within a 30-day testing period) in the case of common stock or more than 45 days (within a 90-day testing period) in the case of preferred stock (sec. 901(k)). The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than these holding periods, and to indirect foreign tax credits for taxes paid by a lower-tier foreign corporation or a RIC where any of the

required stock in the chain of ownership is held for less than these holding periods.

New Law

The new law would also disallow foreign tax credits for gross-basis foreign withholding taxes with respect to any item of income or gain from property if the taxpayer who receives the income or gain has not held the property for more than 15 days (within a 30-day testing period), exclusive of periods during which the taxpayer is protected from risk of loss. The bill does not apply to foreign tax credits that are subject to the original law disallowance with respect to dividends. The bill also does not apply to certain income or gain that is received with respect to property held by active dealers. Rules similar to the original law disallowance for foreign tax credits with respect to dividends apply to foreign tax credits that are subject to the new law. In addition, the bill authorizes the Treasury Department to issue regulations providing that the new law does not apply in appropriate cases.

Effective Date Comments & Observations

For amounts paid or accrued more than 30 days after October 22, 2004.

Foreign Tax Credits Treatment of Deemed Payments Under Section 367(d)

Old Law

In the case of transfers of intangible property to foreign corporations by means of contributions and certain other nonrecognition transactions, special rules apply that are designed to mitigate the tax avoidance that may arise from shifting the income attributable to intangible property offshore. Under section 367(d), the outbound transfer of intangible property is treated as a sale of the intangible for a stream of contingent payments. The amounts of these deemed payments must be commensurate with the income attributable to the intangible. The deemed payments are included in gross income of the U.S. transferor as ordinary income, and the earnings and profits of the foreign

corporation to which the intangible was transferred are reduced by such amounts.

Prior to the enactment of the new law, the Service had not directly addressed the characterization of the deemed payments for purposes of applying the foreign tax credit separate limitation categories.

New Law

Under the new law deemed payments under section 367(d) would be treated as royalties for purposes of applying the separate limitation categories.

Effective Date Comments & Observations

For amounts treated as received on or after August 5, 1997 (the effective date of the relevant provision of the Taxpayer Relief Act of 1997).

Under the old law, if deemed payments were treated as proceeds of a sale, then they could fall into the passive category; if the deemed payments were treated like royalties, then in many cases they could fall into the general category (under look-through rules applicable to payments of dividends, interest, rents, and royalties received from controlled foreign corporations).

Under the new law, the payment is treated as a royalty, which in many cases the deemed payments will now fall into the general category.

Inversion Transaction

Old Law

Under existing law, a U.S. corporation may undertake an inversion transaction whereby in one form or another it reincorporates itself in a foreign jurisdiction. While inversion transactions may invoke immediate U.S. tax consequences at the shareholder or corporate level they provide a significant tax benefit to the extent that the newly inverted corporation acquires the U.S. entity's foreign operations. Moreover, the tax benefits of an inverted corporation are significantly enhanced to the extent that the newly inverted company can receive deductible payments (e.g., interest or royalties) from the U.S.

New Law

80 Percent Inversions: An 80 percent inversion is a transaction in which: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity; (2) the former shareholders of the inverted U.S. corporation hold (by virtue of their original ownership in such corporation) 80 percent or more of the vote or value of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign incorporated entity, when considered together with all companies connected to it by a chain of greater than 50 percent ownership (the so-called "expanded affiliated group") does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities conducted by the expanded affiliated group. In such a case the foreign corporation will be treated as a U.S. corporation for U.S. tax purposes.

60 Percent Inversions: A 60 percent inversion is a transaction that meets the definition of an 80 percent inversion except that the 80 percent threshold is not met (i.e., at least 60 percent but less than 80 percent of a foreign-incorporated entity is acquired by the former shareholders of the inverted U.S. corporation). However, unlike in an 80 percent inversion, the inversion transaction in a 60 percent inversion is respected (i.e., the foreign corporation is treated as foreign) but any applicable corporate-level "toll charges" for establishing the inverted structure may not be offset by tax attributes of the inverted U.S. corporation such as net operating losses or foreign tax credits.

Partnership Inversions: If a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership and, after the transaction at least 60 percent of the stock of the foreign-incorporated entity is held by former partners of the partnership and the substantial activities test described above is not met than the partners of the partnership are subject to applicable "toll charges" on the transfer.

Effective Date Comments & Observations

Effective for transactions occurring on or after March 3, 2003.

Taxation of Stock Options on Inversion Transactions

Old Law

Under existing law the income taxation of a non-statutory compensatory stock option is determined under the Section 83 rules that apply to property transferred in connection with the performance of services. In general, recipients of nonstatutory stock options that do not have a readily ascertainable fair market value at the time of grant need not include the value of the option in gross income until such option is exercised. The tax treatment of other forms of stock-based compensation such as restricted stock is also determined under Section 83. With such forms of compensation the excess of the fair market value of the property over the amount paid, if any, is generally includable in gross income in the first taxable year in which the recipient acquires the rights to such property or the property is not subject to substantial risk of forfeiture.

Additionally, under existing law, holders of stock options (or other forms of stock-based compensation) are not required to recognize any gain in the event that the entity in which the option is held undergoes an inversion transaction.

New Law

The new law provides that specified holders (disqualified individuals) of stock options and other stock-based compensation are subject to an excise tax upon certain inversion transactions.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is 6 months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation or any member of the corporation's expanded affiliated group or would be subject to such requirements if the corporation (or mem-

ber) were an issuer of equity securities referred to in section 16(a). This generally includes officers and directors as well as 10 percent or greater owners of private and publicly held corporations.

The excise tax imposed on the value of the stock compensation at a rate equal to the maximum rate of tax on the adjusted net capital gain of an individual (currently 15 percent). The excise tax also applies to any amount paid directly or indirectly by an inverted corporation or any member of its expanded affiliated group to compensate a disqualified individual for incurring such excise tax.

The excise tax is only imposed on a disqualified individual of an inverted corporation in the event that gain (if any) is recognized in whole or in part by any shareholder in an inverted U.S. corporation that has undergone a 60 percent or 80 percent inversion.

Effective Date Comments & Observations

Effective for transactions occurring on or after March 3, 2003 except that periods before March 4, 2003 are not taken into account in applying the excise tax to specified stock compensation held or cancelled during the six-month period before the expatriation date.

Elimination of Foreign Personal Holding Company Income and Personal Holding Company Income from Controlled Foreign Corporations

Old Law

Currently, there are several different anti-deferral rules, in which there are detailed coordination rules, that may apply to foreign corporations, including the CFC rules under subpart F, passive foreign investment company rules, foreign personal holding company rules, personal holding company rules and foreign investment company rules.

New Law

The bill (1) eliminate the rules applicable to foreign personal holding companies and foreign investment companies (2) excludes foreign corporations from the application of the personal holding company rules and (3) includes as FPHCI under subpart F, personal services contract income that is subject to the present-law foreign personal holding company rules

Effective Date Comments & Observations

Tax years of foreign corporations beginning after 2004, and tax years of U.S. shareholders ending with or within such tax years of such foreign corporations.

Look-Through Rule on Sale of Partnership Interest for Subpart F

Old Law

The gain on the sale of a partnership interest by a CFC generally constitutes foreign personal holding company income (FPHCI)

New Law

The sale by a CFC of a partnership interest, in which it owns at least a 25 percent capital or profits interests is treated as a sale of the proportionate share of partnership assets attributable to this interest for purposes of determining FPHCI.

Effective Date Comments & Observations

Tax years of foreign corporations beginning after 2004, and taxable years of U.S. shareholders ending with or within such tax years of these foreign corporations.

Section 956 Exception

Old Law

Under section 956, a 10 percent shareholder of a CFC is subject to U.S. tax on their pro rata share

of the CFCs earnings to the extent it is invested in certain U.S. property.

New Law

The new law adds two new exceptions from the definition of U.S. property for these purposes.

The first exception generally applies to securities acquired and held by a CFC in the ordinary course of its trade or business as a dealer in securities. The exception applies only if the CFC dealer: (1) accounts for the securities as securities held primarily for sale to customers in the ordinary course of business; and (2) disposes of these securities (or such securities mature while being held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business.

The second exception generally applies to the acquisition by a CFC of obligations issued by a U.S. person that is not a domestic corporation and that is not: (1) a U.S. 10 percent shareholder of the CFC; or (2) a partnership, estate or trust in which the CFC or any related person is a partner, beneficiary, or trustee immediately after the acquisition by the CFC of this obligation.

Effective Date Comments & Observations

Effective for tax years of foreign corporations beginning after December 31, 2004, and for tax years of United States shareholders with or within which such tax years of such foreign corporations end.

Limitation of Section 956 Exception for Banks

Old Law

Under current law, stemming from the U.S. Court of Appeals for the Sixth Circuit in The Limited, Inc. v Commissioner (286 F3d 324 (6th Cir. 2002), rev'g 113 T.C. 169 (1999)) there is an exception from the definition of U.S. property relating to section 956 with respect to deposits with persons carrying on the banking business.

New Law

The new law limits the applicability of this exception to deposits with: (1) any bank (as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. section 1841(c)), without regard to paragraphs (C) and (G) of paragraph (2) of such section) or (2) any other corporation with respect to which a bank holding company (as defined by section 2(a) of the Bank Holding Company Act of 1956) or financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation

Effective Date Comments & Observations

Effective October 22, 2004.

The Committee reports states that no inference is intended as to the meaning of the phrase "carrying on the banking business" under present law.

Commodities Hedging under Subpart F

Old Law

With respect to transactions in commodities, foreign personal holding company income (FPHCI) generally includes net gains from commodities transactions, but excludes certain gains or losses which arise out of bona fide hedging transactions that are reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of commodities.

Gains or losses that are comprised of active business gains or losses from the sale of commodities are also generally excluded, but only if substantially all of the business of a controlled foreign corporation (CFC) is as an active producer, processor, merchant, or handler of commodities.

New Law

The new law modifies the requirements that must be satisfied for gains or losses from commodities hedging transaction to qualify for exclusion from FPHCI.

Gains or losses from a commodities hedging transaction are excluded if the transaction:

- (1) it satisfies the general definition of a hedging transaction under section 1221(b)(2) and
- (2) if the transaction is clearly identified as a hedging transaction.

The new law also changes the requirements that must be satisfied for active business gains or losses from the sale of commodities to qualify for exclusion from the definition of FPHCI.

Effective Date Comments & Observations

Effective for transactions entered into after 2004.

Elimination of Subpart F on Shipping

Old Law

Subpart F income includes foreign base company shipping income. Foreign base company shipping income generally includes income derived from: the use of an aircraft or vessel in foreign commerce, the performance of services directly related to the use of any such aircraft or vessel, the sale or disposition of any such aircraft or vessel and certain space or ocean activities

New Law

The new law repeals the subpart F rules related to foreign base company shipping income. It also amends the exception from FPHCI applicable to rents or royalties derived from unrelated persons in an active trade or business, by providing a safe harbor for rents derived from leasing an aircraft or vessel in foreign commerce. These rents are excluded from FPHCI if the active leasing expenses comprise at least 10 percent of the profit on the lease.

Effective Date Comments & Observations

Tax years of foreign corporations beginning after 2004, and tax years of U.S.

shareholders ending with or within such tax years of these foreign corporations.

Election to Determine Corporate Tax on Certain International Shipping Activities Using a “Per Ton” Rate

Old Law

Foreign corporations are taxed on U.S. source transportation income on either a net basis if effectively connected with a U.S. trade or business, or on a gross basis at a rate of 4 percent under IRC Section 877. Domestic corporations are taxed on a net basis on worldwide income.

New Law

Corporations may elect to be taxed on a notional basis, by applying the highest corporate tax rate to income calculated by reference to daily net tonnage. This tax would replace the tax on effectively connected income and the gross basis tax under IRC Section 877. The election may be made on a year by year basis.

Effective Date Comments & Observations

Effective for tax years beginning after October 22, 2004.

Election for the notional tax is applied to each qualifying vessel, and applies to all members of the controlled group. Therefore companies must consider the likely effect on the tax liability for each vessel and across the controlled group.

Elections to be taxed on the notional basis must be made by the due date for the tax return (including extensions). Revocations must be made by the 15th day of the 3rd month of the year to be effective for that year, otherwise is effective for the following year.

Delayed Effective Date of Section 883 Regulations (Governing Exclusion of Income from the International Operation of Ships and Aircraft)

Old Law

In general, the regulations under 1.883-1 through 1.883-5 apply to taxable years beginning 30 days or more after August 26, 2003.

New Law

The regulations shall apply to taxable years beginning after September 24, 2004.

Expatriation of Individuals

Old Law

Expatriating U.S. citizens or long term green card holders who have or are presumed to have a primary purpose of tax avoidance, are subject to an alternative tax regime under Section 877, for the ten tax years immediately following the year of expatriation. Under this regime, the individuals are subject to U.S. tax on an expanded category of U.S. source income, generally at tax rates applicable to U.S. citizens.

A tax avoidance motive is presumed for individuals with an average federal tax liability of \$124,000 for the 5 preceding years, or whose net worth is \$622,000 or more. Certain individuals who fall within these rules can submit a ruling request to the Internal Revenue Service regarding whether tax avoidance motivated the expatriation.

Under the gift tax rules, an expatriating individual with an actual/presumed motive of tax avoidance, who makes gifts within 10 years of expatriation, is subject to gift tax on gifts of U.S. situated intangibles. Furthermore, under the estate tax rules, if an expatriating individual dies within the 10 year period, he must include certain closely held foreign corporation stock in his gross estate.

Expatriating individuals must provide the Internal Revenue Service with information about their assets at the date of expatriation.

New Law

Under the new law, the rules applicable to expatriating individuals are revised as follows;

- Expatriating U.S. citizens or long term green card holders are subject to the alternative tax regime under Section 877, UNLESS;
 - (a) Their average annual income tax liability for the prior five years is \$124,000 or less (adjusted for cost of living); AND
 - (b) Their net worth is less than \$2 million.

In addition, expatriating individuals must certify under penalties of perjury that they have complied with U.S. tax laws for the prior five years, and be able to provide evidence upon request.

- Expatriating U.S. citizens or long term green card holders will be treated as U.S. citizens/residents until they give notice of the act of expatriation/termination of residency to the Secretary of State or the Secretary of Homeland Security, together with a statement containing personal and financial information required under Section 6039G. Section 6039G is amended as follows;
 - The scope of information required to be disclosed is expanded
 - The same information is also required for any subsequent year in which the individual is subject to tax under this alternative regime
 - The Penalty for failure to provide this information is increased to \$10,000.
- An expatriated individual who is subject to tax under this regime will be subject to full U.S. federal tax for any tax year during the ten year period in which he is present in the U.S. for more than 30 days. Therefore, he would be taxable in the U.S. on his worldwide income, subject to gift tax in respect of any transfers by gift, and estate tax on worldwide assets should he die during that year.

For certain individuals who are present in the U.S. by virtue of performing services for an unrelated employer, up to 30 days of U.S. presence is disregarded, provided that they can show strong ties to a foreign country by virtue of birth or

marriage, or, provided that they have minimal prior physical presence in the US.

- An expatriated individual subject to tax under this regime, who within the ten year period, makes a gift of certain closely held foreign corporation stock, will be subject to gift tax, based on the proportion of the corporation's assets that are situated in the US. Likewise, individuals who die while subject to tax under this regime, must include in their U.S. taxable estate interests in certain foreign corporations that they control, to the extent that the corporation holds assets situated in the US.
- Expatriated individuals subject to tax under this alternative regime are required to file an annual tax return for each applicable year, even if no U.S. federal tax is due.

Effective Date Comments & Observations

These provisions apply to individuals who relinquish their U.S. citizenship or terminate their long term residency after June 3, 2004.

Residence and Source Rules Relating to U.S. Possessions

Old Law

In general, there are special rules in place governing the taxation of individuals who are bona fide resident of U.S. possessions and who receive income from sources within U.S. possessions. In determining whether an individual is bona fide resident of a U.S. possession, a subjective test is used, looking at the facts and circumstances of each case.

New Law

The new law provides an objective, more narrow definition of bona fide residence; namely the individual must satisfy a two prong test; (1) he was physically present in the possession for at least 183 days of the tax year; and (2) he does not have a tax home outside the possession and does not have a closer connection to the U.S. or to a foreign country

In determining whether the source of income is from U.S. possessions, or whether income is effectively connected to a trade or business within a possession, similar rules are to be applied to those used in determining whether income is from U.S. sources, or is effectively connected with a U.S. trade or business.

Individuals asserting that they became, or cease to be, bona fide residents of a possession are required to file a notice to that effect with the Internal Revenue Service.

Finally, penalties for failure to file certain informational returns are increased from \$100 to \$1,000.

Effective Date Comments & Observations

Effective for tax years ending after October 22, 2004.

Importation of Built-In Losses

Old Law

In a tax-free transfer of property to a corporation in exchange for stock of the transferee corporation, the basis of the stock received by the transferor is the basis of the transferor of the property transferred prior to the transfer. The transferee's basis in the property received is also the basis of such property to the transferor prior to the transfer. Similar rules apply to property received in a nontaxable reorganization as well as to property received by a corporation in a nontaxable liquidation (regardless of the tax residency of the transferor).

New Law

The new law requires that any built-in loss property acquired in a Section 351 exchange or nontaxable reorganization from a transferor that would not be subject to U.S. income tax on any gain or loss with respect to such property immediately before the transfer must be marked down to fair market value in the hands of the transferee immediately after the transfer. Likewise, the new law generally prescribes similar basis reduction results in the case when a foreign corporation is liquidated

into a U.S. corporation in a complete liquidation to which Section 332 applies.

Effective Date Comments & Observations

Effective for transactions after October 22, 2004.

Translation of Foreign Taxes

Old Law

For taxpayers that take foreign income taxes into account when accrued, present law provides that the amount of the foreign tax credit generally is determined by translating the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount at the average exchange rate for the taxable year to which such taxes relate. This rule does not apply to any foreign income tax: (1) that is paid after the date that is two years after the close of the taxable year to which such taxes relate; (2) of an accrual-basis taxpayer that is actually paid in a taxable year prior to the year to which the tax relates; or (3) that is denominated in an inflationary currency (as defined by regulations).

Foreign taxes that are not eligible for translation at the average exchange rate generally are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid. However, the Secretary is authorized to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.

New Law

For taxpayers that are required under present law to translate foreign income tax payments at the average exchange rate, the new law provides an election to translate such taxes into U.S. dollar amounts using the exchange rates as of the time such taxes are paid, provided the foreign income taxes are denominated in a currency other than the taxpayers's functional currency. Any election under the new law applies to the taxable year for which the election is made and to all subsequent taxable years unless revoked with the consent of the Secretary. The law authorizes the Secretary to issue regulations that apply the election to foreign

income taxes attributable to a qualified business unit.

Effective Date Comments & Observations

Effective with respect to taxable years beginning after December 31, 2004.

Interest Paid by Foreign Partnerships and Foreign corporations

Old Law

As a general rule, interest income from bonds, notes or other interest-bearing obligations of non-corporate U.S. residents or domestic corporations is treated as U.S.-source income. Interest on obligations of foreign corporations and foreign partnerships is generally treated as foreign-source income. However, Treasury regulations provide that a foreign partnership is a U.S. resident for purposes of this rule if at any time during its taxable year it is engaged in a trade or business in the United States. Therefore, any interest received from such a foreign partnership is U.S.-source income.

Notwithstanding the rules above, with respect to a foreign corporation engaged in a U.S. trade or business (or having gross income that is treated as effectively connected with the conduct of a U.S. trade or business), interest paid by such U.S. trade or business is treated as if it were paid by a domestic corporation (i.e., such interest is treated as U.S.-source income).

New Law

Interest paid by foreign partnership is treated similar to the treatment of interest paid by foreign corporations. Thus, interest paid by a foreign partnership is treated as U.S.-source income only if the interest is paid by a U.S. trade or business conducted by the partnership or is allocable to income that is treated as effectively connected with the conduct of a U.S. trade or business. The law applies only to foreign partnerships that are predominantly engaged in the active conduct of a trade or business outside the United States.

Effective Date Comments & Observations

Effective for taxable years beginning after December 31, 2003.

Complete Liquidation of U.S. Holding Company into Foreign Parent Corporation

Old Law

Dividends paid by a U.S. corporation to nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business are generally subject to a U.S. withholding tax on the gross amount of such income at a rate of 30 percent. The 30-percent withholding tax may be reduced pursuant to an income tax treaty.

U.S. withholding tax is generally not imposed with respect to a distribution of a U.S. corporation's earnings to a foreign corporation in complete liquidation of the subsidiary, because the distribution is treated as made in exchange for stock and not as a dividend. Regulations under section 367(e) provide that the Commissioner may require a domestic liquidating corporation to recognize gain on distribution in liquidation made to a foreign corporation if a principal purpose of the liquidation is the avoidance of U.S. tax.

New Law

The law treats any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation as a dividend, provided that the U.S. holding company was in existence for less than five years.

Effective Date Comments & Observations

Effective for distributions occurring on or after October 22, 2004.

Income Tax Changes Affecting S Corporations

Number of Eligible Shareholders

Old Law

One of the requirements to qualify as an S corporation is that the corporation can have no more than 75 shareholders.

New Law

The maximum number of shareholders is increased from 75 to 100. In addition, in determining the number of shareholders, family members can elect to be treated as one shareholder. For this purpose, a family member is defined as the common ancestor and lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor. Except as otherwise provided by regulations, the election may be made by any member of the family.

Effective Date Comments & Observations

Effective for tax year beginning after December 31, 2004.

Bank S Corporation Eligible Shareholders to Include IRAs

Old Law

There is no provision allowing an IRA to be a shareholder of a bank that is an S corporation.

New Law

An IRA (including a Roth IRA) is permitted to be a shareholder of a bank that is an S corporation, but only to the extent of the bank stock held by the IRA as of the date of enactment, October 22, 2004. Also, the sale by an IRA to the IRA bene-

fiary of bank stock held by the IRA on October 22, 2004, is exempt from prohibited transaction treatment.

Effective Date Comments & Observations

Effective October 22, 2004.

Exclusion of Investment Securities Income from Passive Investment Income Test for Bank S Corporations

Old Law

When an S corporation has accumulated earnings and profits at the close of the tax year and more than 25% of its gross receipts are from passive investment income, the S corporation is subject to tax at the highest corporate tax rate on its excess net passive income. Passive investment income is generally comprised of income from royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock or securities.

New Law

Interest income and dividends on assets required to be held by a bank, a bank holding company, or a financial holding company, are not treated as passive investment income for purposes of the S corporation passive investment income rules.

Effective date Comments & Observations

Effective for tax years beginning after December 31, 2004.

Disregard of Unexercised Powers of Appointment in Determining Potential Current Beneficiaries of ESBT

Old Law

For purposes of determining the number of eligible shareholders of an S corporation, each person that is entitled to receive a distribution (a "potential current beneficiary") from an Electing Small

Business Trust ("ESBT") is treated as one shareholder. If an ineligible shareholder becomes a potential current beneficiary of an ESBT, the ESBT has 60 days to dispose of the stock to avoid disqualification as an S Corporation.

New Law

In determining the number of potential current beneficiaries of an ESBT, an unexercised power of appointment will be disregarded. In addition, the trust will have one year (as opposed to 60 days) after an ineligible shareholder becomes a potential current beneficiary to dispose of the S corporation stock.

Effective Date Comments & Observations

Effective for tax years beginning after December 31, 2004.

Transfer of Suspended Losses Incident to Divorce

Old Law

Any loss or deduction that is not allowed to a shareholder of an S corporation due to lack of basis in the stock or debt of the corporation is treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

New Law

In the case of S corporation stock that is transferred to a spouse or former spouse incident to divorce, the loss or deduction that is disallowed due to lack of basis will be treated as incurred by the corporation in the succeeding taxable year on behalf of the transferee spouse or former spouse.

Effective Date Comments & Observations

Effective for tax years beginning after December 31, 2004.

Relief from Inadvertently Invalid Qualified Subchapter S Subsidiary Elections and Terminations

Old Law

Inadvertent invalid S corporation elections and terminations may be waived. There is no provision for inadvertent invalid qualified subchapter S subsidiary elections and terminations.

New Law

The IRS may now also waive inadvertent invalid qualified subchapter S subsidiary elections and terminations.

Effective date Comments & Observations

Effective for elections and terminations after December 31, 2004.

Information Returns for Qualified Subchapter S Subsidiaries

Old Law

All of the assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary are treated as assets, liabilities and items of income or deduction of the parent S corporation.

New Law

The Secretary of the Treasury is now authorized to provide guidance regarding information returns of qualified subchapter S subsidiaries.

Effective date Comments & Observations

Effective for tax years beginning after December 31, 2004.

Use of Passive Activity Loss and At-Risk Amounts by QSST Income Beneficiaries

Old Law

Income from an S corporation whose stock is held by a qualified subchapter S trust ("QSST"), with respect to which the beneficiary makes an election, is taxed to the beneficiary. However, for purposes of determining the tax consequences of the disposition of S corporation stock held by a QSST, the trust, and not the beneficiary, is treated as the owner of the stock.

New Law

The beneficiary of a QSST is generally allowed to deduct suspended losses under the at-risk and passive activity loss rules when the S corporation stock is disposed of by the trust.

Effective date Comments & Observations

Effective for tax year ending after December 31, 2004.

Repayment of Loans for Qualifying Employer Securities

Old Law

An employee stock ownership plan ("ESOP") is a defined contribution plan that is designated as an ESOP and is designated to invest primarily in qualifying employer securities. Special rules apply to ESOPs that do not apply to other types of qualified retirement plans, including a special exemption from the prohibited transaction rules.

An ESOP of a C corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a dividend paid with respect to qualifying employer securities held by the ESOP is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire employer securities (whether or not allocated to participants). In the case of a dividend paid with respect to any employer security that is allocated to a participant, this relief does not apply unless

the plan provides that employer securities with a fair market value of not less than the amount of the dividend is allocated to the participant for the year which the dividend would have been allocated to the participant.

For tax years beginning after December 31, 1997, a qualified retirement plan (including an ESOP) may be a shareholder of an S corporation.

New Law

In addition to the provisions described above, an ESOP maintained by an S corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a distribution made with respect to S corporation stock that constitutes qualifying employer securities held by the ESOP is used to make payments on a loan that was used to acquire the securities (whether or not allocated to participants). This relief does not apply in the case of a distribution with respect to S corporation stock that is allocated to a participant unless the plan provides that stock with a fair market value of not less than the amount of such distribution is allocated to the participant for the year which the distribution would have been allocated to the participant.

Effective Date Comments & Observations

Effective for distributions made with respect to S corporation stock after December 31, 1997.

Income Tax Changes Affecting Partnerships

Income from Discharge of Indebtedness – Satisfaction of Debt with Partnership Interest

Old Law

When a partnership transfers a partnership interest to a creditor in satisfaction of debt, no Code provision requires the partnership to realize cancellation of indebtedness income.

New Law

When a partnership transfers a partnership interest to a creditor in satisfaction of partnership debt, the partnership is required to recognize cancellation of indebtedness income as if the debt were satisfied with money in an amount equal to the fair market value of the partnership interest transferred. Any discharge of indebtedness income is allocable to the partners in the partnership immediately prior to the transfer.

Effective Date Comments & Observations

Effective for transfers occurring on or after October 22, 2004.

Contribution of Built-in Loss Property

Old Law

The partnership's adjusted tax basis in contributed property is equal to the contributor's adjusted tax basis in such property immediately prior to contribution. A partnership is required to allocate items of income, gain, loss, and expense with respect to contributed property so as to take into account any built-in gain or loss at the time of contribution. When a contributing partner transfers its interest in the partnership, the transferee is treated as the contributing partner.

New Law

With respect to contributed property that is subject to a built-in loss, the partnership must treat the fair market value of the property at the time of contribution as the partnership's tax basis for purposes of determining allocations with respect to the non-contributing partners. The built-in loss is taken into account solely for purposes of determining the contributing partner's allocable share of partnership items. If the contributing partner's partnership interest is transferred or liquidated, the built-in loss is eliminated.

Effective Date Comments & Observations

Effective to contributions after October 22, 2004.

Adjustments to Basis of Partnership Property

Old Law

No adjustment is made to the basis of the partnership assets as the result of the distribution of property to a partner or a sale or exchange of an interest in the partnership unless the partnership files an election to adjust the basis of its assets.

New Law

An adjustment to the basis of the assets of the partnership is mandatory if there is a distribution of property to a partner and there is a substantial basis reduction. If the combined total of the loss recognized by the partner plus the amount by which the partner's basis in the distributed property exceeds the partnership's basis in such property exceeds \$250,000, there is a substantial basis reduction. Similarly, an adjustment is mandatory if there is a sale or exchange of a partnership interest and after the transfer, the partnership has a substantial built-in loss. A substantial built-in loss exists if the partnership's basis in its assets exceeds the fair market value of such assets by over \$250,000.

Certain investment partnerships may elect to be exempt from the mandatory

basis adjustment provisions required as a result of a sale or exchange of a partnership interest. Under the exception, however, losses are not allowed to the transferee partner except to the extent that it is shown that such losses exceed the transferor's loss on its interest in the partnership.

A securitization partnership is not treated as having a substantial basis reduction or a substantial built-in loss and therefore the mandatory adjustment provisions do not apply.

Effective Date Comments & Observations

Effective for distributions and sales or exchanges after October 22, 2004.

The provisions for electing investment partnerships contain certain grandfathering rules.

Income Tax Changes Affecting Individuals

Exclusion on the Sale or Exchange of a Principal Residence

Old Law

Taxpayers may generally exclude up to \$500,000 (\$250,000 for single individuals) of gain from the sale of a principal residence. The exclusion is available for those taxpayers who have owned and used the residence as a principal residence for at least two out of the five years preceding the sale.

New Law

The exclusion is not available if the property was acquired in a tax-free like-kind exchange within the five-year period prior to its sale.

Effective Date Comments & Observations

Effective for sales after October 22, 2004.

Deductions for Attorneys Fees and Costs of Discrimination Suits

Old Law

Legal fees and expenses attributable to non-business income or to employment related unlawful discrimination lawsuits are only allowed as miscellaneous itemized deductions subject to the 2 percent of adjusted gross income (AGI) reduction for miscellaneous itemized deductions and the 3 percent of adjusted gross income overall itemized deduction limitation. Also, because these expenses are treated as miscellaneous itemized deductions, they are not allowed as deductions for purposes of computing alternative minimum tax (AMT). Thus, taxpayers who receive large amounts for non-business and/or employment legal settlements net of applicable attorney fees have to pay tax on

the gross amount of the settlement without benefit of a deduction for the legal fees.

New Law

Legal fees and expenses attributable to non-business income are allowed as a reduction against the gross amount of the settlement, rather than as miscellaneous itemized deductions.

Effective Date Comments & Observations

Effective for fees and expenses paid after October 22, 2004.

Allowing these expenses as reductions against gross income also increases the limits on medical expenses, contributions, and miscellaneous deductions that are subject to Adjusted Gross Income (AGI) limitations.

Deduction of State and Local Sales Taxes

Old Law

No itemized deduction is permitted for any State and/or local sales taxes.

New Law

Taxpayers that itemize their deductions may elect to deduct either State and/or local income taxes or State and/or local sales and use taxes. Taxpayers may use either actual sales tax records or sales tax tables the IRS will provide increased by the sales tax on large purchases, such as a car.

Effective Date Comments & Observations

Effective for taxable years beginning on or after January 1, 2004 and before January 1, 2006

This election is especially significant to taxpayers who reside in Florida, Alaska, Nevada, South Dakota, Texas, Washington and Wyoming, which do not have an income tax.

Deductions for Donated Automobiles, Boats, and Planes

Old Law

Contributions of more than \$250 need to be substantiated with contemporaneous documentation.

The contribution deduction is equal to the item's fair market value (FMV) at the time of the contribution.

New Law

Contributions of "qualified vehicles," i.e., cars, boats, airplanes, non-inventory items, having a value of more than \$500 must be substantiated with a contemporaneous written acknowledgement from the donee organization containing specific required information and certifications. For example, if the qualified vehicle is sold after the contribution, the deduction is limited to the amount of the gross proceeds, and information is required to be provided to the taxpayer within 30 days after the sale (and to the IRS in a manner to be provided by the IRS) that includes the amount of gross proceeds from the sale.

Effective Date Comments & Observations

Effective for contribution made after December 31, 2004.

These new rules effectively delay the determination of the deduction for vehicles to be sold until the vehicle is sold and the gross proceeds are known and communicated to the taxpayer by the donee organization. Tax return extensions or amended returns may be necessary where contributions of qualified vehicles are made close to the end of the year.

Taxpayers planning donations of qualified vehicles in 2005 should consider making them in 2004 to avoid these new rules.

Deductions for Contributions of Patents and Other Intellectual Property

Old Law

The amount of deduction for contributions of property is generally the FMV of the property at the time of the contribution. Certain contributions of tangible personal property unrelated to the donee's charitable purpose or to certain private foundations are limited to the lesser of the FMV or the donor's basis in the donated property. Contributions of intellectual property are not limited to the donor's basis in the donated property.

New Law

The amount of the donation for patents and other intellectual property is initially limited to the lesser of the FMV or the donor's basis. The donor, in later years, may be entitled to additional deductions for donations of "qualified intellectual property" based on specified percentages of "qualified donee income" the donee receives from the property. The additional charitable deductions from qualified donee income are only allowed when the cumulative amount of the qualified donee income from each year exceeds the amount of the original claimed deduction. "Qualified intellectual property" includes; patents, certain copyrights, trademarks, trade names, trade secrets, know-how, and certain software.

Effective Date Comments & Observations

Effective for contributions after June 3, 2004

The rules applicable to taxpayers obtaining additional charitable deductions from intellectual property do not apply to property donated to private foundations, except private operating foundations.

Additional Donor Reporting Requirements for Property Contributions Over \$500

Old Law

Property contributions over \$500 are required to be reported on Form 8283. If the value of the donation exceeds \$5,000, except for money or publicly traded securities, the donor is required to obtain a qualified appraisal of the property. A summary of that appraisal or the appraisal itself, in the case of art work in excess of \$20,000, is required to be attached to the taxpayers return.

New Law

If the deduction is more than \$500,000, the donor must attach to the return the qualified appraisal.

Effective Date Comments & Observations

Effective for contributions made after June 3, 2004.

If a taxpayer fails to meet the substantiation requirements, the deduction will not be denied if it is established the taxpayer's failure was due to "reasonable cause" and not willful neglect.

Installment Agreements

Old Law

Taxpayers can enter into installment agreements to pay their taxes if the agreement covered the entire tax liability. If the liability does not exceed \$10,000, upon application by a taxpayer, the IRS is required to enter into an installment agreement, assuming certain conditions are met.

New Law

The IRS is permitted, but is not required, to enter into an installment with a taxpayer even if the agreement does not provide for full payment of the liability over the life of the agreement. These agreements can extend beyond three years. Installment agreements that the IRS is required to enter into require payment of the liability over not more than three years.

Effective Date Comments & Observations

These rules are effective for installment agreements entered into after October 22, 2004.

An installment agreement may be revoked or adjusted if circumstances change or a taxpayer does not adhere to the provisions of the agreement. Therefore, even if the installment agreement reached with the IRS calls for satisfaction of less than the full liability, the IRS can demand full payment of the tax liability if the taxpayer does not comply with the conditions of the agreement.

Income Tax Changes Affecting Deferred Compensation

Nonqualified Deferred Compensation Plans

Old Law

Old law surrounding nonqualified deferred compensation (NQDC) plans integrates a range of tax principles, doctrines and statutes to arrive at the general rule that the timing of income inclusion is primarily a function of whether the arrangement is funded or unfunded. If the arrangement is unfunded, then the compensation is generally includible in gross income when actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture. In general, an arrangement is funded if there has been a transfer of property in connection with the performance of services. For example, vested contributions made to an irrevocable trust for the benefit of a participant are currently taxable. Alternatively, a deferral will be respected if the NQDC benefit is payable out of corporate assets and such assets are subject to the claims of the corporation's general creditors.

New Law

New Internal Revenue Code (IRC) Sec. 409A provides specific guidelines within which the deferral of compensation will be respected. Failure to fall within the statutory guidelines results in immediate income recognition plus interest and penalty. The statute governs the treatment of a range of NQDC plans, including excess benefit plans and SERPs, as well as restricted stock, performance shares, phantom stock/stock appreciation rights, and IRC Sec. 457(f) plans.

IRC Sec. 409A makes deferred compensation that is not subject to a substantial risk of forfeiture currently taxable, unless the statutory provisions regarding distributions, acceleration of benefits, and elections are met. A substantial risk of forfeiture exists where an individual's rights to compensation are conditioned upon the future performance of substantial services.

IRC Sec. 409A limits the availability of distributions to six events: separation from service; death; disability; a specified time or fixed schedule stipulated in the plan at the time of deferral; an unforeseen emergency; and a change in control or ownership of the plan sponsor. Key employees of publicly traded companies are prevented from taking a distribution until six months after the separation date. If a plan permits a subsequent election to change the timing or form of distributions, such election will not take effect for 12 months. Furthermore, unless the subsequent election is related to a specific event such as death, disability, or unforeseen emergency, distributions will be delayed for an additional period of five years. Acceleration of benefits distributions generally is not permitted, thus preventing a participant from receiving an immediate payout, subject to forfeiture of a percentage of the amount of NQDC.

NQDC plans are frequently elective in nature, i.e., compensation income will be deferred as long as the forfeiture restriction does not lapse. In general, the initial election to defer for a taxable year must be made no later than the close of the preceding taxable year. For example, a plan may require a participant to perform services for the employer in 2006 in order to receive a bonus in 2007 based on those services. Under IRC Sec. 409A, the participant will have to elect the deferral before the end of 2005 in order to defer income recognition until 2007. Specific rules

apply to newly eligible participants and to performance based bonus programs.

Assets transferred to offshore Rabbi trusts would be subject to immediate taxation. Trusts with financial health provisions, known as "springing" rabbi trusts, provide assets to be distributed upon a change in the employee's financial health. A "springing" plan would cause all amounts deferred to be included in a participant's gross income to the extent not otherwise subject to a substantial risk of forfeiture.

Effective Date Comments and Observations

Effective for amounts deferred after Dec. 31, 2004.

If a plan operates in violation of IRC Sec. 409A, the affected participant would be immediately taxed on all deferral amounts and required to pay interest at the IRS underpayment rate, plus 1 percent. An additional 20 percent penalty would be assessed on the taxable amounts.

Note that rules regarding NQDC income recognition are moving away from the doctrines of constructive receipt or economic benefit in favor of clearer and more direct statutory guidelines. Thus, where a substantial risk of forfeiture to the receipt of NQDC exists or is maintained, a NQDC election continues to be respected even if the distributions, acceleration of benefits and election provisions of IRC Sec. 409A are not provided.

As year-end approaches, plan sponsors must review and amend their NQDC plans to satisfy the new statutory structure. Further, to the extent required, NQDC plan elections must be timely made on a form consistent with the newly enacted statute. These modifications will likely require regulatory guidance.

Material discussed in this Tax Letter is meant to provide general information and should not be acted on without obtaining professional advice appropriately tailored to your individual needs.

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