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The 2004 Corporate Tax and FSC/ETI Bill: The American Jobs Creation Act of 2004

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Summary

On October 11, 2004, the Senate approved a conference report on H.R. 4520, the American Jobs Creation Act of 2004 (AJCA); the House had approved the measure on October 7. The President signed the measure into law on October 22; it became Public Law 108-357. The act began as a solution to a long-simmering dispute between the United States and the European Union (EU) over the U.S. tax code's extraterritorial income exclusion (ETI), which provided a tax benefit for U.S. exports. As it was enacted, however, AJCA was a broad, omnibus business tax bill, incorporating a host of corporate tax provisions, both broad and narrow. In general, the measure contains a mix of revenue-raisers and tax cuts applying principally to businesses and corporations. According to Joint Committee on Taxation revenue estimates it would produce a net reduction of tax revenue amounting to \$8.7 billion over five years but would be essentially revenue-neutral over 10 years, increasing revenue by \$1 million.

The act's provisions fall into the following broad categories:

- phase out and repeal of the ETI benefit for exporting;
- a phased-in deduction applicable to income from domestic production;
- tax cuts for business investment abroad;
- other business tax cuts, including a number of tax cuts for agriculture;
- other tax cuts, including an option for individuals to deduct state and local sales taxes;
- assorted revenue raisers in areas such as tax shelters, corporate inversions, and leasing transactions.

This report provides a summary of the act's most important provisions as well as a brief legislative history. It will not be updated.

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On October 11, 2004, the Senate approved a conference report on H.R. 4520, the American Jobs Creation Act of 2004 (AJCA); the House had approved the measure on October 7. The President signed the measure into law on October 22; it became Public Law 108-357. The act began as a solution to a long-simmering dispute between the United States and the European Union (EU) over the U.S. tax code's extraterritorial income exclusion (ETI), which provided a tax benefit for U.S. exports. As it was enacted, however, AJCA was a broad, omnibus business tax bill, incorporating a host of corporate tax provisions, both broad and narrow. In general, the measure contains a mix of revenue-raisers and tax cuts applying principally to businesses and corporations. According to Joint Committee on Taxation revenue estimates it would produce a net reduction of tax revenue amounting to \$8.7 billion over five years but would be essentially revenue-neutral over 10 years, increasing revenue by \$1 million.¹

Underlying the act's net revenue over 10 years is a wide assortment of both revenue-losing and revenue-raising measures. In broad outline, AJCA's principal features on the revenue-reducing side are: enactment of a major new tax benefit for domestic (rather than foreign) production, provision of a variety of tax cuts for multinational firms, and an assortment of relatively narrow business tax cuts spread throughout the tax code. On the revenue-raising side, the act's major provisions are repeal of the ETI export benefit and enactment of an assortment of other revenue-raising items, including provisions designed to restrict corporate tax shelters, measures designed to curtail fuel tax evasion, and more stringent rules for certain charitable contributions. The act also contains a budget-neutral buyout provision for tobacco quotas.

The Act's Development

The DISC/FSC/ETI Controversy

The Act began as a legislative response to the controversy between the United States and the EU over the U.S. tax code's ETI benefit for exporters — a controversy

¹ Revenue estimates appearing here and elsewhere in this report are from: U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 4520, the "American Jobs Creation Act of 2004,"* JCX-69-04, Oct. 7, 2004. Posted on the Joint Committee's website, at [<http://www.house.gov/jct/x-69-04.pdf>], visited Oct. 22, 2004.

that had a history spanning three decades.² The dispute began with the enactment in 1971 of ETI's statutory ancestor, the Domestic International Sales Corporation (DISC) tax benefit for exporting. Shortly after its enactment, DISC encountered difficulties with the General Agreement on Tariffs and Trade (GATT), an agreement among most of the world's trading nations governing permissible trade practices. European nations and several other countries lodged a complaint with GATT arguing that DISC violated GATT's prohibition against export subsidies. In response, the United States lodged a counter-claim, arguing that the "territorial" tax systems operated by several European countries (France, the Netherlands, and Belgium) also provided prohibited export subsidies because they did not tax income earned outside the taxing country's borders.

In 1981, a GATT panel generally supported the position of the European countries, concluding that DISC was, indeed, a prohibited export subsidy. The panel also concluded, however, that under certain circumstances, a territorial tax system did not provide prohibited export subsidies — that a country need not tax income earned outside its own territory. Thus, although the United States did not concede that DISC was prohibited, in 1984 it enacted a revamped export benefit that was designed with an eye to the GATT requirements. The new Foreign Sales Corporation (FSC) provisions attempted to achieve GATT-legality by incorporating elements of a territorial tax system; firms obtained the benefit by selling their exports through FSC subsidiary corporations that were required to be incorporated abroad.

The European countries did not accept the GATT-compatibility of FSC, but the controversy nonetheless faded into the background for a period. In 1997, however, the EU began proceedings against FSC under the auspices of the World Trade Organization (WTO), which had replaced GATT. As did GATT, the WTO prohibited export subsidies, and the EU argued that FSC, like DISC before it, was a prohibited subsidy. As with GATT, a WTO panel issued a ruling against the U.S. tax benefit in October, 1999, and while the United States appealed the ruling, in February, 2000, the WTO Appellate Body rejected the appeal. In general, the WTO rulings held that FSC violated the WTO agreements by providing a subsidy contingent on exporting. The panels generally rejected the analogy between FSC and territorial taxation.

The United States responded in November, 2000, by enacting the ETI provisions, which again attempted to redesign the export tax benefit in a way that would be WTO-compatible. (The ETI provisions were enacted by Public Law 106-519.) In contrast to FSC, ETI did not require exports to be sold through a foreign subsidiary, but instead categorized income that qualified for the export benefit as being "extraterritorial." The EU, however, lodged a complaint against the new ETI provisions maintaining they were an export subsidy like DISC and FSC before it. In August, 2001, a WTO panel issued a report that concluded that ETI was not WTO-compatible, and in January 2002, the WTO Appellate Body rejected a U.S. appeal. Shortly thereafter, policymakers in both Congress and the Bush Administration

² For a history of the dispute, see CRS Report RL31660, *A History of the Extraterritorial Income (ETI) and Foreign Sales Corporation (FSC) Export Tax Benefit Controversy*, by David L. Brumbaugh.

expressed the view that mere redesign of the export tax benefit was not a workable solution. Looming behind the WTO panel rulings was the possibility of sanctions — WTO rules permit a complaining country to ask for permission to impose retaliatory tariffs, and in August, 2002, the WTO approved an EU request for permission to impose up to \$4 billion in tariffs on goods imported from the United States. The EU indicated, however, that it would not impose the tariffs so long as the United States made progress towards becoming WTO-compliant. In March, 2004, however, the EU began a phased-in application of its tariffs.

Congressional Action

Beginning in 2002, the chief legislative responses to the ETI controversy were alike in their proposals to eliminate ETI rather than to attempt another redesign of the benefit. Where the various bills differed, however, was in the additional tax benefits they proposed to offset what policymakers viewed as the likely detrimental effects of ETI's repeal on segments of the U.S. economy. As noted below, the relative merits of the different alternative tax benefits were hotly debated. Further, as legislation in both chambers of Congress progressed, its scope tended to expand beyond a tight focus on ETI and its economic antidotes to include a relatively broad range of primarily business provisions dispersed throughout the various sections of the tax code.

The first major legislative response to the WTO rulings against ETI came in July, 2002, with the introduction of H.R. 5095 (107th Congress) by Chairman Thomas of the House Ways and Means Committee. The bill proposed outright repeal of the ETI provisions rather than their redesign. At the same time, the bill proposed a number of tax cuts for U.S. firms operating abroad — reductions aimed at improving the competitiveness of U.S. firms in international markets. The foreign tax cuts applied in two broad parts of the U.S. international tax system: to the rules limiting the U.S. foreign tax credit, and to the “deferral” tax benefit for overseas investment and its associated limitations under the tax code’s Subpart F provisions. Generally, the tax cuts provided more generous foreign tax credit rules and relaxed aspects of Subpart F’s limitation on deferral. In addition to its repeal of the ETI benefit, the bill contained a number of revenue-raising items. Chief among these were new restrictions on tax shelters and limits on “earnings stripping” and corporate “inversions” or “expatriation.” (Earnings stripping is generally the shifting of income by foreign parent firms out of the U.S. tax jurisdiction by means of interest payments by U.S. subsidiaries to their foreign parents. Corporate inversions are corporate reorganizations where a firm switches the country of its parent holding corporation from the United States to a foreign country with low tax rates.) Estimates by the Joint Committee on Taxation (JCT) indicated the bill would result in a net reduction in tax revenue of \$6.4 billion over five years and \$1.1 billion over 10 years. No action was taken on H.R. 5095 before the end of the 107th Congress.

Early in the 108th Congress, Representatives Crane and Rangel introduced H.R. 1769, containing an alternative approach. Like H.R. 5095, the bill proposed repeal of the ETI provisions. However, instead of providing tax cuts for overseas investment, H.R. 1769 proposed to replace ETI with a tax deduction that would apply only to domestic production. The bill was considerably narrower in scope than H.R.

5095, containing no provisions other than its repeal of ETI and domestic-production deduction. The bill's sponsors stated that it would be "revenue neutral" — raising the same amount of tax revenue that it was expected to lose.

In July, 2003, Chairman Thomas introduced a new ETI bill as H.R. 2896; a somewhat modified version of the bill was approved by the Ways and Means Committee on October 28. The new bill incorporated many of the elements of H.R. 5095 from the previous Congress but also proposed a number of tax benefits that would be restricted to domestic investment. In broad outline, the bill proposed to repeal ETI, implement tax cuts for overseas investment, enact new tax benefits for domestic investment, and offset part of the revenue cost by means of several revenue-raisers, generally in the areas of earnings stripping, expatriation, and tax shelters. A version of H.R. 2896 differing only slightly from that reported by the Ways and Means Committee was estimated by the JCT to reduce revenue by \$21.1 billion over five years and \$59.8 billion over 10 years.

In October, 2003, the Senate Finance Committee approved S. 1637, an ETI bill sponsored by Chairman Grassley. Like the Ways and Means bill, the Finance Committee measure proposed to repeal ETI and replace it with a mix of tax benefits, including both items benefitting foreign income and benefits restricted to domestic investment. In the international area, there was considerable overlap between S. 1637 and H.R. 2896, with S. 1637 proposing tax cuts in the area of the foreign tax credit and deferral. For domestic investment, the Finance Committee bill proposed a deduction for domestic production rather than the rate cut proposed by the Ways and Means bill, although the Finance Committee's deduction would have provided a benefit of similar size to the Ways and Means rate reduction. After extended debate, the full Senate approved a somewhat modified version of the bill on May 11, 2004. The JCT estimated the Senate-approved bill would reduce tax revenue by \$14.6 billion over five years and increase revenue by \$2.8 billion over 10 years. The provisions chiefly responsible for the significant revenue differences between the Senate bill and H.R. 2896 were revenue raisers. While both bills contained revenue offsets in the broad areas of tax shelters and corporate inversions and earnings-stripping, the Senate bill's provisions were estimated to produce more revenue. Also, the Senate bill contained a number of revenue-raisers not contained in the Ways and Means bill, including new restrictions on tax avoidance through leasing transactions with tax-indifferent entities.

The Senate passed its version of an ETI bill before the full House acted on H.R. 2896, and on June 4, Chairman Thomas introduced a modified version of the Ways and Means Committee bill as H.R. 4520. The new bill had the same general thrust as S. 1637 and H.R. 2896 before it — it proposed to repeal ETI while enacting a mix of domestic and international benefits while offsetting part of the cost with assorted revenue-raisers. The bill contained several differences, however, from the previous Ways and Means Committee bill. Prominent among these were the addition of a provision that would permit individuals to deduct State and local sales taxes rather than corresponding income taxes. The bill also contained a tobacco "buyout" provision under which the federal price-support and production control system for tobacco producers would be ended, but producers would be compensated for the system's elimination. The full House approved the bill on June 17. According to JCT estimates, the bill would reduce revenues by \$32.4 billion over five years and

\$35.7 billion over 10 years. (The revenue loss estimates include an increase in outlays for tobacco buyouts.)

On July 15, the Senate approved a version of H.R. 4520 that substituted its own revenue language from S. 1637, as passed in May. The Senate measure also added its own tobacco buyout provision.

On October 7, the House approved a conference agreement on H.R. 4520; the Senate approved the agreement on October 11. The President signed the measure on October 22. The JCT estimated that the conference agreement will reduce revenue by \$8.7 billion over five years and would be virtually revenue-neutral over 10 years, increasing revenue by \$1 million. Brief descriptions of the act's most important elements are contained in the following section. In general terms, the act achieved estimated revenue neutrality by including revenue-raising items larger in size than the House bill but smaller than the Senate's and by paring back revenue-losing items from both the House and Senate bills. In general, however, it retains the general thrust common to both bills: repeal of ETI, provision of a domestic production benefit, tax cuts for foreign income, and revenue raising items applying to corporate tax shelters and other corporate areas.

A summary of the act's most important provisions follows.

The Act's Provisions

As enacted, AJCA contains a wide variety of corporate and business tax provisions dispersed throughout the tax code. The act's provisions, however, fall into the following broad categories:

- phase out and repeal of the ETI benefit for exporting;
- a phased-in deduction applicable to income from domestic production;
- tax cuts for business investment abroad;
- other business tax cuts, including a number of tax cuts for agriculture;
- other tax cuts, including an option for individuals to deduct state and local sales taxes;
- assorted revenue raisers in areas such as tax shelters, corporate inversions, and leasing transactions.

In terms of revenue impact, the bill contains \$149.0 billion in estimated revenue losing items over 10 years and a like amount of revenue-raising items. Among the tax cuts, the domestic production deduction is the largest item in terms of its revenue impact, accounting for just over half (51%) of the estimated revenue loss. The

international provisions combined for slightly less than a third (29%) of the bill's revenue losses. Repeal of ETI accounts for one-third (33%) of the revenue raised while other revenue raisers account for two-thirds (67%).

Phase-Out of the ETI Export Tax Benefit

As noted at the outset of the report, the starting point of the legislation was the controversy between the United States and the EU over the extraterritorial income exclusion's tax benefit for exporting. Under prior law, the ETI benefit allowed firms to exclude between 15% and 30% of their export income from taxes. The conference agreement phases out the ETI over three years. Under the Act, a firm will be able to claim 100% of its otherwise applicable ETI benefit in 2004, 80% of the benefit in 2005, 60% of the benefit in 2006, and none of the benefit in 2007.

The provision is estimated to increase revenue by \$49.2 billion over 10 years.

Tax Deduction for Domestic Production

AJCA phases in a new tax deduction that would generally be equal to 9% of domestic production when fully phased in. For a firm paying the maximum corporate tax rate of 35%, the phased-in deduction would be similar to a reduction in the tax rate to 31.85%, thus providing a tax benefit similar in magnitude of the tax-rate cut proposed in the House-passed bill, but not included in the conference agreement. The phase-in would provide a 3% deduction in 2005 and 2006, a 6% deduction in 2007, 2008, and 2009, and the full 9% deduction thereafter. The maximum credit a firm could claim is limited to 50% of wages paid by the firm.

The deduction applies to what the Act defines as "qualified production activities income," which generally includes income from manufacturing, mining, and agriculture, although it does not include income from provision of most services. Exceptions are construction, engineering, or architectural services. Firms would not have to be organized as corporations to claim the deduction; sole proprietorships and pass-through entities such as S corporations could earn the deduction and pass it through to their owners.

According to Joint Tax Committee estimates, the deduction would reduce tax revenue by \$76.5 billion over 10 years.

Tax Cuts for Business Investment Abroad

Two basic structural components of the U.S. tax system in its international context are the foreign tax credit and the deferral principle. Under the foreign tax credit, U.S. individuals and firms are permitted to credit foreign taxes they pay against U.S. taxes they would otherwise owe on their foreign-source income. Importantly, however, foreign tax credits are limited to offsetting U.S. tax on income earned abroad rather than in the United States. The deferral principle (or simply "deferral") permits U.S. firms to indefinitely postpone paying U.S. tax on foreign income as long as the foreign income is earned through a foreign-chartered subsidiary corporation, and the income is reinvested abroad by the foreign subsidiary; the

income is subject to U.S. tax only when it is ultimately repatriated to the United States parent corporation as dividends or other income. Deferral, too, is limited, in this case by the tax code's Subpart F provisions. Under Subpart F, U.S. parents of foreign subsidiary corporations are subject to U.S. tax on the subsidiaries' income from passive investment as well as certain other types of income whose source is thought to be relatively flexible.

Over the decades, the scope of both deferral and the foreign tax credit has varied to some extent, with much of the ebb and flow resulting from legislated changes in the foreign tax credit limitation and related rules and in Subpart F. AJCA generally follows this pattern with the foreign tax credit limitation and (to a lesser extent) with Subpart F.

The Act's international provisions would reduce revenue by an estimated \$46.2 billion over 10 years.

Provisions Related to the Foreign Tax Credit. In terms of its revenue impact, the single largest international provision in the bill is a change in the rules governing the *allocation of interest expense* for purposes of the foreign tax credit limitation. The provision is estimated to reduce revenue by \$14.4 billion over 10 years. As noted above, the foreign tax credit's limitation provides that foreign tax credits can offset only the portion of a taxpayer's U.S. tax liability that falls on foreign- rather than domestic-source income; foreign taxes that exceed this limit cannot be credited in the year paid. (Such foreign taxes are termed "excess credits" in tax parlance.) It follows from this stipulation that in calculating its foreign tax credit limitation, a taxpayer must allocate its gross income as well as its deductible expenses between domestic and foreign sources.

For a taxpayer that has paid foreign taxes at a high rate (and that has excess foreign tax credits) the rules for allocating costs and income can be crucial. In the case of interest or other expenses, an item of cost that is allocated to foreign rather than domestic income can reduce the proportion of net income classified as foreign-source income, which, in turn, reduces the portion of the U.S. pre-credit tax liability that applies to foreign-source income, and which thus reduces the maximum amount of creditable foreign taxes. For a firm with excess credits, the allocation of a cost to foreign rather than domestic sources can thus increase after-credit taxes. Such an allocation offsets any tax savings produced by the deductibility of foreign-allocated costs from taxable income. In effect, a firm with excess credits loses the deductibility of costs allocated to foreign sources.

The tax code and associated IRS regulations contain elaborate rules for allocating income and expenses between foreign and domestic sources. Prior to AJCA, firms were required to allocate interest on the basis of the location of their assets. For example, if one-third of a firm's assets were located abroad, one-third of its interest expense would generally be allocated to foreign sources. Importantly, however, while a firm's ownership stake in a foreign firm was included in the calculation, the subsidiary's debt-financed assets were not. Further, while the parent's interest expense could be allocated to foreign sources, none of a subsidiary's expense entered the calculation. AJCA changes these rules, implementing a so-called "worldwide" allocation regime. Under it, interest is still allocated on the basis

of assets. However, all of a subsidiary's assets are included in the calculation as is a subsidiary's interest expense. The net result is a reduction in the share of interest allocated to foreign sources, which increases creditable foreign taxes, thus reducing a firm's after-credit U.S. taxes.

A second foreign tax credit provision alters the treatment of *domestic losses* for purposes of the foreign tax credit limitation. In general, if a firm incurs a loss for tax purposes (a "net operating loss," or NOL), the loss can be carried back up to two years and used to reduce taxable income (and thus taxes) earned in the previous years, potentially generating a tax refund. If NOLs are not exhausted by carrybacks, they can be saved, carried forward, and deducted in a future year. (NOLs can be carried forward up to 20 years.) For purposes of the foreign tax credit limitation, however, a firm that incurs a loss with respect to its domestic operations but positive foreign income is, in effect, required to deduct the loss from foreign income, thus eliminating its potential carryforward as an NOL. And as noted above, if a firm has excess credits, deductible expenses that are allocated to foreign sources generate no tax savings. Accordingly, if a firm incurred a domestic loss for a year under prior law, the loss produced no tax savings in the year it was incurred and at the same time could not be carried forward as an NOL. The loss thus generated no tax savings in the current year or in future years. AJCA permits taxpayers that incur a domestic NOL in a particular year to recharacterize a part of their U.S.-source income earned in future years as foreign-source income, thus, in effect, restoring the tax-saving potential of the loss as though it were an NOL. The act limits the amount of income that can be recharacterized to 50% of a firm's U.S.-source income. The provision is estimated to reduce revenue by \$5.6 billion over 10 years.

Another major AJCA foreign tax credit provision consolidates the number of *separate foreign tax credit limitations, or "baskets."* Prior to AJCA, taxpayers were required to calculate separate foreign tax credit limitations for certain types of income. The purpose of the separate baskets was to prevent the "cross crediting" of foreign taxes — that is, to prevent high foreign taxes paid on one stream of foreign income from shielding other more lightly-taxed foreign income from residual U.S. taxes that might be due on that income. Under prior law, nine separate limitations applied. A partial list includes an "overall" limitation for most active business income, income from passive investment, income subject to high foreign withholding taxes, financial services income, and shipping income. AJCA consolidated the number of separate baskets to just two: an overall basket, and a basket for income for passive investment. The provision is estimated to reduce revenue by \$7.9 billion over 10 years.

In a manner similar to NOLs, foreign tax credits that exceed the credit's limitation in a particular year can be carried back and carried forward. The carryback period under prior law was two years and the carryforward period five years. AJCA limits the *foreign tax credit carryback* period to one year but extends the *foreign tax credit carryforward* period to 10 years. The provision is expected to reduce revenue by \$6.9 billion over 10 years.

The Act also eliminates a restriction for the *foreign tax credit under the alternative minimum tax (AMT)*. Under prior law, foreign tax credits were permitted

to offset no more than 90% of a taxpayer's AMT liability. The provision is expected to reduce revenue by \$3.4 billion over 10 years.

Provisions Related to Deferral and Subpart F. In general, U.S. residents and U.S.-chartered corporations are subject to U.S. tax on their worldwide income — that is, income from foreign as well as domestic sources. Foreign-chartered corporations, however, are generally subject to U.S. only on their U.S.-source income; the United States does not tax foreign corporations on their foreign income. The deferral principle (or simply “deferral”) results from this structure: U.S. firms can indefinitely postpone U.S. tax on their foreign-source income if the income is earned by a foreign subsidiary and reinvested abroad. U.S. taxes apply only when the income is remitted to the U.S. parent corporation as dividends or other payments.

While deferral is available for most active business operations overseas, the U.S. tax code places a number of limitations on its scope. The most important of these “anti-deferral regimes” is posed by the tax code's Subpart F provisions. In general, Subpart F taxes the U.S. parents of foreign corporations controlled by U.S. firms on certain types of foreign income whether it is repatriated to the U.S. parent corporation or not. (Such foreign firms are termed Controlled Foreign Corporations, or CFCs, in tax-code parlance.) In general, income subject to Subpart F includes income from passive investment (interest, dividends, rents, royalties, and similar income), as well as certain other types of income whose source is thought to be easily manipulated by taxpayers. AJCA contains a number of provisions that expand the scope of deferral either by contracting the scope of Subpart F or by other means.

In terms of revenue impact, AJCA's largest alteration in the deferral structure is a temporary, one-year 85% deduction for *earnings repatriated to U.S. parent firms from foreign subsidiaries* during the one-year period. The one-year window specified by the Act is (at a firm's election) either the first tax year after AJCA's enactment, or the tax year immediately preceding enactment. The amount of dividends eligible for the deduction would be limited to repatriations in excess of those during a base period specified by the Act.

Another provision of AJCA provides more generous *treatment of partnership interests under Subpart F*. In addition to its current taxation (rather than deferral) of passive income such as interest, dividends, rents, and royalties, Subpart F includes in its scope income from the sale of both property that generates such income and gain from the sale of partnerships. The Act institutes a “look through” rule to sales of partnership interests, under which the resulting income is generally Subpart F income only if the underlying partnership assets are of a type that generates Subpart F income.

As noted above, along with income from passive investment, Subpart F denies deferral to certain other types of income whose source is thought to be easily shifted, for tax purposes. One such type of income is what the tax code terms “*foreign base company shipping income*,” which is general income from the use of an aircraft or vessel in the conduct of foreign commerce. AJCA removes foreign base company shipping income from Subpart F.

The deduction for repatriated earnings is estimated to reduce revenue by \$3.3 billion; the look-through treatment for partnership interests is expected to reduce revenue by \$1.0 billion, and the provisions for shipping income are estimated to reduce revenue by \$1.0 billion, each over 10 years.

Other Business Tax Cuts

Along with its tax deduction for domestic production and its international tax cuts, AJCA contains numerous business tax reductions in a variety of other areas. In general, these tend to be relatively narrowly focused. These other business tax cuts sum to \$8.1 billion over 10 years, according to JCT estimates.

Several of the tax cuts apply to capital cost recovery — that is, the rules that govern how rapidly firms are permitted to deduct amounts that represent the recovery of investment in capital assets rather than profits earned on the investment. Among these tax cuts, the largest is a *temporary increase in the “expensing” tax benefit*. In general, when firms acquire tangible assets such as machines and equipment, they are required to deduct the acquisition cost only gradually, as depreciation. The tax code’s section 179 expensing provisions, however, permit firms to deduct a certain amount of investment in the year the property is placed in service. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) temporarily increased the maximum annual expensing limit to \$100,000. However, the cap was scheduled to revert to its prior level of \$25,000 after 2005. In addition, the amount that can be expensed is reduced by the amount by which a firm’s eligible investment exceeds \$400,000. Again, this was a temporary level set by JGTRRA and was scheduled to revert to its prior level of \$200,000 after 2005. AJCA extends JGTRRA’s higher limitation and phase-out threshold for two years, through 2007. The Act also extends for two years a temporary JGTRRA provision for the indexing of the limitation and phase-out threshold. The expensing extension is expected to reduce revenue by \$1.1 billion over 10 years.

Other cost recovery provisions in AJCA include more generous treatment for *leasehold improvements, restaurant improvements, and property depreciated under the “income forecast” method of depreciation* (such property includes motion pictures and sound recordings). The tax code requires improvements to a leasehold to be depreciated separately from the original, improved asset, but over the same recovery period as applicable to the improved asset. This treatment applies even if the recovery period is longer than the term of the lease. For leased buildings, AJCA provides a 15-year recovery period for improvements to non-residential structures (non-residential structures must generally be depreciated over 39 years.) The provision is temporary, applying to improvements made before 2006. The Act also provides a 15-year recovery period for improvements to restaurant property, again for improvements prior to 2006. In the case of the income-forecast method of depreciation, AJCA expands its scope by permitting participations and residuals to be included in the basis (i.e., depreciable value) of assets depreciated under the income-forecast method. The changes for leasehold improvements are expected to reduce revenue by \$1.5 billion, the restaurant provisions by \$0.5 billion, and the income forecast changes by \$0.6 billion, each over 10 years.

The Act includes 10 provisions applying specifically to *Subchapter S corporations*—corporations that meet certain requirements relating to being closely-held and that are not subject to corporate-level tax. Two of the more generally applicable of the changes relate to the number of permissible shareholders. Under prior law, S corporations could have no more than 75; AJCA increases the limit to 100. In addition, the Act provides that members of the same family are to be treated as a single shareholder for purposes of the limitation. Another, less general, provision exempts S corporations that are banks from the tax code's provision that prohibits individual retirement accounts from owning S-corporations. Combined, the Subchapter S provisions are estimated to reduce revenue by \$1.2 billion over 10 years.

Aside from its tobacco buyout provisions, AJCA contains a set of tax provisions for the *agriculture industry*. In general, the provisions while numerous, are relatively narrow. A partial list includes a provision preventing farm income-averaging from triggering the alternative minimum tax; more generous rules for deferring tax in the case of livestock lost in floods, droughts, and other weather conditions; more generous treatment of the small ethanol-producer tax credit in the case of cooperative; and several provisions applying to timber. Together, the agriculture provisions are expected to reduce revenue by \$0.5 billion.

Other Tax Cuts

The great majority of AJCA's provisions are directed at businesses, whether C corporations, S corporations, partnerships, and other pass-through entities, or sole proprietorships. There are, however, several individual income tax provisions; the most prominent provides a temporary, *optional tax deduction for state and local sales taxes* rather than income taxes. Under prior law, individuals who itemize their deductions are permitted a tax deduction for state and local income taxes and property taxes, but not for sales taxes. AJCA permits taxpayers to elect an itemized deduction for sales taxes in lieu of the deduction for income (but not property) taxes. Taxpayers will have the option of basing their deduction on their own receipts or on an amount determined under tables to be issued by the IRS. The tables will be based on state and local levels of sales tax as well as adjusted gross income, consumption levels by state, and number of family members. The provision will be applicable for 2004 and 2005.

The provision is estimated to reduce tax revenue by an estimated \$5.0 billion over the FY2005-FY2014 estimating window; the reductions would occur, however, only in FY2005 and FY2006.

Revenue-Raising Provisions

Notwithstanding the tax cuts outlined in this report's preceding section, AJCA is estimated by the Joint Committee on Taxation to be virtually revenue-neutral over its first 10 years, increasing revenue by \$1 million over FY2005-2014. AJCA obtains this anticipated result with various revenue-raising provisions that together amount to \$148,968 million over the period, offsetting the Act's revenue losses of \$148,967 million. Like the act's tax cuts, the revenue-raising items apply principally to

businesses; like the tax cuts, they tend to be narrow but numerous and scattered through different parts of the tax code. The chief general areas, however, from which revenues are raised are:

- repeal of the extraterritorial income tax exclusion for exports (described above);
- new restrictions on tax shelters and other tax avoidance transactions, including limits on tax savings from leasing transactions;
- restrictions on tax savings that can be obtained by expatriation on the part of either businesses or individuals;
- more stringent rules relating to charitable donations;
- provisions aimed at reducing fuel-tax evasion.

Restrictions on Leasing Transactions.³ Apart from repeal of ETI, the largest single revenue-raising item in the Act is its new restrictions on tax savings firms can obtain by means of leasing transactions with “tax indifferent” entities such as U.S. local governments or foreign institutions or entities. In broad terms, such savings can occur, for example, when a taxable firm purchases an asset (say, subway cars) from a tax-exempt entity (say, a municipality), claims the associated depreciation deductions, and rents the asset back to the tax-exempt entity who actually uses the asset. In effect, a lease can in some cases be used to transfer the depreciation or other tax benefits an asset generates from a tax-exempt entity — who cannot use the benefits — to a taxable entity who can.

Over the years, a number of restrictions have been enacted that are designed to limit such transactions — transactions that have no motive or substance other than their tax-reducing function. One such rule — the so-called Pickle rule — generally provides that the depreciation recovery period for an asset leased to a tax-exempt entity can be no shorter than 125% of the lease term, and must use the straight-line method of depreciation (a less generous method than other methods available under the tax code). Under prior law, assets constituting Qualified Technological Equipment (QTE) under the tax code’s definition were explicitly exempt from the Pickle rule.

AJCA places several new restrictions on leasing transactions. Its major provisions: extend the Pickle rule to QTEs; expand the definition of a lease term for purposes of the 125% limitation to include service contracts; and limit deductions that can be claimed with respect to property leased to tax-exempt entities to gross income derived from asset’s lease.

³ For background on leasing transactions and taxes, see CRS Report RL32479, *Tax Implications of SILOs, QTEs, and Other Leasing Transactions with Tax-Exempt Entities*, by Maxim Shvedov.

The leasing provisions are estimated to increase revenue by \$26.6 billion over 10 years.

Other Tax Shelter Provisions.⁴ AJCA's contains limitations aimed at several other specific types of transactions that the act labels "tax shelters." One such provision places restrictions on transactions that generate *built-in losses*. The particulars of built-in loss transactions vary. In general, however, the key to the transactions is the acquisition by taxable U.S. firms of other firms or assets whose basis exceeds their market value. ("Basis" is the amount a taxpayer can deduct from its gross proceeds from the sale of an asset in order to determine taxable profit.) Thus, if a taxpayer sells the asset in such a transaction, the amount that is deductible exceeds taxable proceeds. Built-in losses occur when a taxable U.S. firm acquires an asset and arranges to have a basis in the asset that is less than the acquired asset's market value. In effect, the taxable acquiring firm will have purchased a tax deduction. One type of transaction that apparently lends itself to generating built-in losses is the acquisition of foreign corporations; in such cases, the losses are said to have been "imported" into the U.S. tax jurisdiction by the acquiring firm. In general, AJCA attempts to restrict the import of built-in losses by providing that the acquiring firm's basis in an imported asset is its fair market value. The act also places limitations on built-in losses in the case of certain exchanges of property for stock (section 351 transactions).

Other AJCA tax shelter provisions address tax shelters in general; they are provisions designed to reduce the practice of tax sheltering in general rather than to suppress particular types of transactions. One provision applies a penalty for taxpayers who fail to provide required information for a list of "reportable transactions" specified in the tax code. (While prior law contained the list of reportable transactions, it provided no penalties.) A second provision modifies (in the case of tax shelters) the existing penalties relating to the accuracy of a taxpayer's tax payment.

Apart from the leasing changes, the provisions the act explicitly characterizes as applying to tax shelters are estimated to raise \$6.7 billion over 10 years.

Corporate "Inversions" or "Expatriation" and Expatriate Individuals. A considerable amount of attention has been attracted in recent years by the apparently growing number of U.S. firms that undertake tax-saving "*inversion*" *reorganizations*. The tax-saving nature of the reorganizations results from the broad way in which the United States defines its tax jurisdiction — in general, U.S. taxes apply to the worldwide income of U.S.-chartered corporations (foreign as well as domestic), but the United States does not tax the foreign-source income of foreign-chartered firms. In an inversion, a U.S. firm whose top-tier, holding corporation is chartered in the United States reorganizes so that the firm's ownership is vested in a newly-created foreign parent corporation chartered in a low-tax foreign country or tax haven. The firm's stockholders exchange their ownership in the former U.S. parent for stock in the new foreign parent, and the reorganization typically does not

⁴ For additional information, see CRS Report RL32193, *Anti-Tax-Shelter and Other Revenue-Raising Tax Proposals*, by Jane G. Gravelle.

involve the shift of substantial activity to the new foreign parent's host country. Thus, little changes in substance. The firm, however, is no longer subject to U.S. corporate-level tax on its foreign income.

AJCA defines two types of inversions and subjects each to a different tax regime. The first type of inversion is generally a reorganization where the owners of the former U.S. parent own 80% or more of the new foreign parent's stock. If this threshold is met, the new foreign parent is subject to U.S. tax as though it were a U.S.-chartered corporation; the tax savings from the inversion are thus nullified. The second type of inversion is a reorganization where less than 80% but more than 60% of the foreign parent is owned by the former U.S. parent's stockholders. In the case of such inversions, gain that the inverting firm is required to recognize on foreign assets transferred to the new foreign parent is not permitted to be offset by tax attributes such as net operating losses and foreign tax credits.

In some instances, an inversion can give rise to capital gains taxes at the individual shareholder level. If an inverting firm's officers do not face similar treatment (for example, because of compensation in the form of stock options) and instead have a greater stake in the inversion's corporate-level tax savings, a corporate governance issue may arise. Here, AJCA applies an excise tax to stock-related compensation of an inverting firm's officers.

AJCA's provisions add to existing restrictions on the tax savings individuals can potentially achieve by relinquishing their U.S. citizenship and moving abroad. The tax savings for individuals who expatriate can result as follows: as with U.S.-chartered corporations, individuals who are U.S. citizens are subject to U.S. tax on their worldwide income, but foreign citizens do not pay U.S. tax on their foreign income. In addition, foreign citizens who do not reside in the United States are exempt from U.S. tax on certain types of U.S.-source income, including capital gains and interest income. Absent special restrictions, then, an individual could conceivably save U.S. tax by renouncing his citizenship and moving abroad. To restrict such strategies, however, the U.S. tax code provides that a U.S. citizen who relinquishes his citizenship in order to avoid taxes is subject to full U.S. taxes on his U.S.-source income for a period of 10 years. Individuals whose income is above a certain threshold are treated as having expatriated to avoid taxes, although individuals in certain limited categories can ask the IRS for a ruling to the contrary. AJCA tightens the existing restrictions in several respects, including the implementation of an objective test for the presence of a tax-avoidance motive.

Combined, the corporate inversion and individual expatriate provisions are estimated to increase revenue by \$1.3 billion over 10 years.

Charitable Contributions. AJCA has three revenue-raising provisions in the area of charitable contributions. One applies to *contributions of intellectual property* such as patents, trademarks, and certain types of copyrights. Under prior law, donors of such property were in some circumstances permitted to deduct the fair market value of the property; AJCA generally limits the deduction to the lesser of the taxpayer's basis or the property's fair market value. In addition, however, the Act permits an additional deduction in years following the contribution that is based on a specified percentage of additional income generated by the contributed asset.

A second provision applies to *donations of automobiles and other vehicles*. Under prior law, deductions were generally permitted for the fair market value, subject to certain substantiation requirements. In the case of vehicles that are sold by a recipient charity without any intervening use, AJCA limits the deduction to the gross sales proceeds. The Act also imposes new substantiation requirements.

An additional provision in the area of charitable contributions requires increased reporting for *non-cash contributions*.

The charitable contribution provisions are estimated to increase revenue by a combined \$6.1 billion over 10 years.

Fuel-Tax Evasion. The Act contains numerous provisions designed to curtail evasion of fuel taxes — an area that Federal Highway Administration officials have characterized as a “serious and growing problem.”⁵ The most prominent of the Act’s measures include moving the point of collection of aviation fuel tax from its sale to its removal from a refinery or terminal; institution of registration requirements for pipeline or vessels operators claiming the exemption applicable to bulk transfers; and implementation of more stringent rules for the use tax on heavy highway-vehicles.

The fuel-tax evasion provisions are estimated to increase revenue by a combined \$22.1 billion over 10 years.

Other Revenue-Raising Items. Other relatively large revenue-raising items in AJCA are an extension through FY2013 of customs user-fees scheduled to expire on April 20, 2005, and a provision shifting the payment of alcohol-fuel excise tax credits from (in effect) the highway trust fund to the general fund. The customs provision would increase revenue by \$18.6 billion over 10 years; the alcohol fuels credit provision causes the revenue estimate to increase by \$6.0 billion, but occurring over FY2011-FY2014.

⁵ Testimony of FHA Administrator Mary E. Peters before the House Committee on Transportation and Infrastructure, Subcommittee on Highways, Transit and Pipelines, May 20, 2003, available on the subcommittee’s website at [<http://www.house.gov/transportation/>] (visited Oct. 22, 2004).