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# Agricultural Law Digest

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## **American Jobs Creation Act of 2004:**

### **A Summary of Selected Provisions**

— by Neil E. Harl\* and Roger A. McEowen\*\*

The American Jobs Creation Act of 2004, H.R. 4520, was signed into law on October 22, 2004. The lengthy bill repealed the Extra-Territorial Income Exclusion Act of 2000, Pub. L. No. 106-519, and also enacted into law numerous other provisions of significance to farm and ranch taxpayers.

#### **Repeal of ETI**

The legislation repeals the Extra-Territorial Income Exclusion Act of 2000 effective for transactions after December 31, 2004, subject to transitional rules for 2005 and 2006 and binding contracts in effect on September 17, 2003. **Act Sec. 101(a), (c).**

Although the legislation could be clearer, the Conference Committee Report confirms that the phase-out rule 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. **H. Rep. No. 108-755, 108th Cong., 2d Sess. (2004).**

#### **Deduction for income from domestic production activities**

The Extra-Territorial Income Exclusion Act of 2000 is essentially replaced by a deduction ultimately equal to nine percent *of the lesser of*—(1) the “qualified production activities income” of the taxpayer for the taxable year or (2) taxable income for the year. This taxable income limitation excludes taxpayers with current year net operating losses or with NOL carryovers that eliminate current year taxable income. The transition percentage is three percent for 2005 and 2006 and six percent for 2007, 2008 and 2009. **Act Sec. 102(a), enacting I.R.C. § 199.** The deduction cannot exceed 50 percent of the W-2 wages of the employer for the taxable year. **I.R.C. § 199(b).**

The term “qualified production activities income” equals the taxpayer’s domestic production gross receipts over the sum of the cost of goods sold, other expenses allocable to such receipts and a ratable portion of other expenses and losses not directly allocable to such receipts. **I.R.C. § 199(c).** The provision references some existing guidance for determining the proper allocation of costs and expenses (for example, I.R.C. § 263A rules in determining cost of goods sold and I.R.C. § 861 in determining other costs and expenses).

A key part of the provision is the definition of “domestic production gross receipts” which includes gross receipts derived from—(1) any lease, rental, license, sale, exchange or other disposition of qualifying production property which was manufactured, *produced*, *grown*, or extracted by the taxpayer in whole or significant part within the United States; (2) any qualified film produced by the taxpayer; (3) electricity, natural gas or potable water

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produced by the taxpayer in the United States; (4) construction performed in the United States; or (5) engineering or architectural services performed in the United States (for construction projects in the United States). **I.R.C. § 199(c)(4)(A).**

The Senate bill specifically provided that property would be treated as produced in "significant part" by the taxpayer within the United States if more than 50 percent of the aggregate development and production costs were incurred by the taxpayer in the United States. However, the House bill contained no such guidance and the conference bill follows the House version.

The Conference Committee states, as to electricity—

"In the case of a taxpayer who owns a facility for the production of electricity, whether the taxpayer's facility is part of a regulated utility or an independent power facility, the taxpayer's gross receipts from the production of electricity at that facility are qualified domestic production gross receipts. However, to the extent that the taxpayer is an integrated producer that generates electricity and delivers electricity to end users any gross receipts properly attributable to the transmission of electricity from the generating facility to a point of local distribution and any gross receipts properly attributable to the distribution of electricity to final customers are not qualified domestic gross receipts.

The term specifically does not include the sale of food and beverages prepared by the taxpayer at a retail establishment and the transmission or distribution of electricity, natural gas or potable water. Likewise, the term does not include property leased, licensed or rented by the taxpayer for use by a related person. **I.R.C. § 199(c)(4)(B).**

The deduction is available to S corporations, partnerships, estates, trusts and other pass-through entities and also to individuals. **I.R.C. § 199(d)(1), (2).**

For pass-through entities, the wage limitation is applied by allocating to the pass-through entity individual (such as a partner) the person's allocable share of W-2 wages or a portion of the qualified production activities income allocated to that person for the taxable year. **I.R.C. § 199(d)(1)(B).**

Deductions are allowed to cooperatives engaged in manufacturing, production, growth or extraction and to cooperatives engaged in the marketing of agricultural or horticultural products. **I.R.C. § 199(d)(3).**

The new deduction is allowed for alternative minimum tax purposes. The provision allows for the qualified production activities income deduction for purposes of computing minimum taxable income (including adjusted current earnings). The AMT deduction is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income without regard to this deduction. **I.R.C. § 199(d)(6).**

#### **Timber cutting election**

The legislation specifies that an election under I.R.C. § 631(a) made for a taxable year *ending* before the date of enactment of the Act can be revoked by the taxpayer for any taxable year ending after the date of enactment. **Act Sec. 102(c).**

#### **Sec. 179 depreciation**

Under the legislation, expense method depreciation (Section 179 depreciation) is continued for 2006 and 2007 at the level of \$100,000 (inflation adjusted). The figure is \$102,000 for 2004.

**Act Sec. 201, amending I.R.C. § 179(b), (c), (d).**

#### **Livestock sold because of weather-related conditions**

The Act extends from two years to four years the period for reinvestment of the proceeds from sale of livestock held for draft, dairy or breeding purposes because of weather-related conditions.

**Act Sec. 311(b), amending I.R.C. § 1033(e)(2)(A).** The Secretary is given authority to extend, on a regional basis, the period for replacement if the weather-related conditions continue for more than three years. **Act Sec. 311(b), amending I.R.C. § 1033(e)(2)(B).**

The Act also expands the provision on sale because of environmental contamination (I.R.C. § 1033(f)) to apply also to sale of eligible livestock because of weather-related conditions except for investment in real property which is reserved for soil contamination or other environmental contamination. **Act Sec. 311(a), amending I.R.C. § 1033(f).**

The Act amends the provision applicable to the one-year deferral for sale or exchange of livestock because of weather-related conditions to state that an election is valid if made during the replacement period for livestock under I.R.C. § 1033(e) if I.R.C. § 1033(e) applies to a sale or exchange of livestock. That means the election can be made within the four-year period. **Act Sec. 311(c), amending I.R.C. § 451(e).**

The various amendments in Act Sec. 311 apply to any taxable year with respect to which the due date (without regard to extensions) for the return is after December 31, 2002. **Act Sec. 311(d).**

#### **Income averaging and AMT**

The Act provides that, in computing alternative minimum tax, the regular tax liability for farmers and fishermen is determined without regard to income averaging. Thus, a farmer receives the full benefit of income averaging. **Act Sec. 314(a), amending I.R.C. § 55(c).** The Act also extends income averaging to fishermen. **Act Sec. 314(b), amending I.R.C. § 1301(a).** These amendments are effective for taxable years beginning after December 31, 2003. **Act Sec. 314(c).**

#### **Capital gain treatment for timber**

Under the Act, in the case of a sale of timber by the owner of land from which the timber is cut, the requirement that a taxpayer retain an economic interest in the timber in order to treat gains as capital gains under I.R.C. § 631(b) does not apply. Outright sales of timber by the landowner will qualify for capital gains treatment in the same manner as sales with a retained economic interest qualify presently, except that the usual tax rules relating to the income from the sale of timber will apply. **Act Sec. 315(a), amending I.R.C. § 631(b).** The provision is effective for sales after December 31, 2004. **Act Sec. 315(c).**

#### **Expensing of reforestation expenditures**

The Act allows up to \$10,000 of qualified reforestation expenditures to be deducted in the year paid or incurred (expensed). Qualified expenditures above \$10,000 are to be amortized over 84 months. **Act Sec. 322(a), amending I.R.C. § 194(b).** The Act also repeals the reforestation credit. **Act Sec.**

**322(d), repealing I.R.C. § 46.** The amendments apply to expenditures paid or incurred after the date of enactment. **Act Sec. 322(e).**

#### **Tobacco buy-out**

The Act repeals the tobacco farm program, effective with the 2005 crop, going back to the Agricultural Adjustment Act of 1938, 7 U.S.C. § 1311 *et seq.*, and eliminating references to tobacco, in exchange for contract payments in 2005 through 2014. **Act Sec. 611.**

#### **Luxury SUVs**

The Act limits the expense method depreciation under I.R.C. § 179 for sport utility vehicles to \$25,000. "Sport utility vehicle" is defined as four-wheeled vehicle, primarily designed to carry passengers over public streets, roads and highways, which is not subject to I.R.C. § 280F (limiting depreciation for "passenger automobile") and which is rated at not more than 14,000 pounds gross vehicle weight. The term does not include vehicles designed to have a seating capacity of more than nine persons behind the driver's seat, equipped with a cargo area of at least six feet in interior length which is an open area or is designed for use as an open area but is enclosed by a cap and is not readily accessible from the passenger compartment or has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat and has no body section protruding more than 30 inches ahead of the leading edge of the windshield. **Act Sec. 910(a), amending I.R.C. § 179(b)(6).** The provision is effective for property placed in service after the date of enactment. **Act Sec. 910(b).**

#### **Depreciating leasehold improvements and restaurant property**

The Act classifies "qualified leasehold improvement property" and "qualified restaurant property" as 15-year property for depreciation purposes if placed in service before January 1, 2006. **Act Sec. 211, amending I.R.C. § 168(e)(3)(E).** "Qualified restaurant property" means I.R.C. § 1250 property which is an *improvement* to a building if placed in service more than three years after the building was first placed in service and more than 50 percent of the square footage is devoted to preparation and consumption of prepared meals. **I.R.C. § 168(e)(7).** Qualified leasehold property has the meaning given to the term by I.R.C. § 168(k)(3) with specified exceptions. **I.R.C. § 168(e)(6).** Both categories of property are required to use straight-line depreciation. **I.R.C. § 168(b)(3)(G), (H).** The provision is effective for property placed in service after the date of enactment of the Act. **Act Sec. 211(f).**

#### **S corporations**

The Act provides that a husband and wife (and their estates) are treated as one shareholder and, in the case of a family with respect to which an election is in effect, all members of the family are treated as one shareholder. **Act Sec. 231(a), amending I.R.C. § 1361(c)(1).** The provision is effective for taxable years beginning after December 31, 2004. **Act Sec. 231(c)(1).**

The Act also raises the limitation on the number of shareholders in an S corporation from 75 to 100, effective for taxable years beginning after December 31, 2004. **Act Sec. 232(a), (b), amending I.R.C. § 1361(b)(1)(A).**

The Act provides for the transfer of suspended losses when stock in an S corporation is transferred between spouses or a former spouse incident to a divorce. **Act Sec. 235(a), amending I.R.C. § 1366(d)(2).**

#### **IRA as owner of S corporation bank**

The legislation allows a trust which constitutes an IRA, including Roth IRAs, to own stock in a bank operated as an S corporation to the extent of the stock held by the IRA as of the date of enactment. **Act Sec. 233, amending I.R.C. § 1361(c)(2)(A).**

#### **Potential current beneficiaries of an electing small business trust**

The Act specifies that an unexercised power of appointment is to be disregarded in determining potential beneficiaries of an ESBT. **Act Sec. 234(a), amending I.R.C. § 1361(e)(2).** The provision is effective for taxable years beginning after December 31, 2004. **Act Sec. 234(b).**

#### **QSST losses and at risk amounts**

Under the legislation, for purposes of I.R.C. §§ 465, 469, the disposition of S corporation stock by the trust is treated as a disposition by the beneficiary, effective for transfers after December 31, 2004. **Act Sec. 236(a), (b), amending I.R.C. § 1361(d)(1).**

#### **Bank S corporations and passive income test**

For purposes of the 25 percent rule for S corporations owning banks, where the S corporation has accumulated earnings and profits, the term "passive investment income" does not include interest income earned or dividends on stock required to be held, effective for taxable years beginning after December 31, 2004. **Act Sec. 237(a).**

#### **Invalid qualified subchapter S subsidiary elections**

The Act provides relief for invalid qualified Subchapter S subsidiary elections, effective for elections made and terminations made after December 31, 2004. **Act Sec. 238(a), (b), amending I.R.C. §§ 1361(b), 1362(f).**

#### **Alcohol and biodiesel fuel credits**

The new law does not change the temporary duty on ethanol. The law eliminates reduced rates of excise tax for most alcohol-blended fuels and imposes the full rate of excise tax on most alcohol-blended fuels (18.3 cents per gallon on gasoline blends and 24.3 cents per gallon of diesel-blended fuel). In place of reduced rates, the legislation creates two new excise tax credits: the alcohol fuel mixture credit and the biodiesel mixture credit. The sum of these credits may be taken against the tax imposed on taxable fuels. The new law allows taxpayers to file a claim for payment equal to the amount of these credits for biodiesel or alcohol used to produce an eligible mixture. Under certain circumstances, a tax is imposed if an alcohol fuel mixture credit or biodiesel fuel mixture credit is claimed with respect to alcohol or biodiesel used in the production of any alcohol or biodiesel mixture, which is subsequently used for a purpose for which the credit is not allowed or changed into a substance that does not qualify for the credit. The legislation eliminates the General Fund retention of certain taxes on alcohol fuels, and credits these taxes to the Highway Trust Fund. The Highway Trust Fund is credited with the full amount of tax imposed on alcohol and biodiesel fuel mixtures. The legislation also extends the present-law alcohol

fuels income tax credit through December 31, 2010. **Act Sec. 301(a), adding I.R.C. § 6426.**

#### **Alcohol fuel mixture excise tax credit**

The provision eliminates the reduced rates of excise tax for most alcohol-blended fuels. Under the provision, the full rate of tax for taxable fuels is imposed on both alcohol fuel mixtures and the taxable fuel used to produce an alcohol fuel mixture. In lieu of the reduced excise tax rates, the provision provides for an excise tax credit, the alcohol fuel mixture credit. The alcohol fuel mixture credit is 51 cents for each gallon of alcohol used by a person in producing an alcohol fuel mixture for sale or use in a trade or business of the taxpayer. For mixtures not containing ethanol (renewable source methanol), the credit is 60 cents per gallon. For purposes of the alcohol fuel mixture credit, an "alcohol fuel mixture" is a mixture of alcohol and a taxable fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel or (2) is used as a fuel by the taxpayer producing the mixture. Alcohol for this purpose includes methanol, ethanol and alcohol gallon equivalent of ETBE or other ethers produced from such alcohol. It does not include petroleum or coal-based alcohols or alcohols with a proof less than 190. The excise tax credit is coordinated with the alcohol fuels income tax credit and is available through December 31, 2010. **Act Sec. 301, adding I.R.C. § 6426(b).**

#### **Biodiesel fuel mixture excise tax credit**

The Act also provides an excise tax credit for biodiesel mixtures. The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a qualified biodiesel mixture for sale or use in a trade or business of the taxpayer. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that—(1) is sold by the taxpayer producing the mixture to any person for use as a fuel or (2) is used as a fuel by the taxpayer producing the mixture. **Act Sec. 301, adding I.R.C. § 6426(c).** In the use of agri-biodiesel, the credit is \$1.00 per gallon. **Act Sec. 301, adding I.R.C. § 6426(c)(2)(B).**

The credit is not available for any sale or use for any period after December 31, 2006. **Act Sec. 301, adding I.R.C. § 6426(c)(6).**

#### **Dividends on cooperative stock without reducing patronage dividends**

The Act provides that net earnings of a cooperative are not to be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent the activities of incorporation or bylaws or other contract with patrons provide that such dividends are in addition to amounts payable to patrons derived from business done with or for patrons during the taxable year. **Act Sec. 312(a), amending I.R.C. § 1388(a).** The amendment is effective for distributions in taxable years beginning after the date of enactment. **Act Sec. 312(b).**

#### **Allocation of small ethanol producer credit**

The Act specifies that, for a cooperative, any portion of the small ethanol producer credit at the election of the cooperative, may be apportioned pro rata among the patrons on the basis of the quantity or value of business done with or for the patrons during the taxable year. **Act Sec. 313(a), adding I.R.C. § 40(g)(6).** The provision is effective for taxable years ending after the date of enactment. **Act Sec. 313(b).**

#### **Modification of cooperative marketing sales**

The Act extends extension of cooperative marketing rules to include value-added processing involving animals. **Act Sec. 316(a), amending I.R.C. § 1388(k).** The provision is effective for taxable years beginning after the date of enactment. **Act Sec. 316(c).**

#### **Extension of declaratory judgments to farmers' cooperatives**

The Act extends declaratory judgments to exempt cooperatives with respect to initial classification or continuing classification of a cooperative as a tax-exempt organization. **Act Sec. 317(a), amending I.R.C. § 7428(a)(1).**

#### **Rural mail carriers**

The Act specifies that if the expenses incurred by an employee for the use of a vehicle as a rural mail carrier exceed the qualified reimbursements for such expenses, the excess is to be taken into account in computing the miscellaneous itemized deduction. **Act Sec. 318(a), amending I.R.C. § 162(o).**

The provision applies to taxable years beginning after December 31, 2003. **Act Sec. 318(c).**

#### **Election to deduct state and local sales taxes in lieu of state and local income taxes**

The Act allows, by election, after 2003, a deduction for state and local income taxes or state and local general sales taxes. The provision states that, in the case of food, clothing, medical supplies and motor vehicles, the fact that the tax does not apply to some or all of the items is not to be taken into account in determining whether the tax applies to a broad range of classes of items. **Act Sec. 501(a), amending I.R.C. § 164(b).**

A compensating use tax is treated as a general sales tax for this purpose. **Act Sec. 501(a), amending I.R.C. § 164(b)(5)(E).** In the case of motor vehicles, if the rate of tax exceeds the general rate, the excess is disregarded. **Act Sec. 501(a), amending I.R.C. § 164(b)(5)(F).**

Tables are to be provided based on average consumption on a state-by-state basis. **Act Sec. 501(a), amending I.R.C. § 164(b)(5)(H).**

#### **Business related credits and AMT**

The Act allows the alcohol fuel credit and the credit for electricity produced from renewable resources (to the extent attributed to electricity or refined coal) against regular and minimum tax. **Act Sec. 711(a), amending I.R.C. § 38(c).**

#### **Sale of principal residence in like-kind exchange within five years of sale**

The Act denies the I.R.C. § 121 exclusion to property acquired in a like-kind exchange within the prior five-year period beginning with the date of property acquisition. The provision is designed to counter situations where—(1) the property is exchanged for residential real property, tax free, under I.R.C. § 1031; (2) the property is converted to personal use; and (3) a tax-free sale is arranged under I.R.C. § 121. **Act Sec. 840(a), amending I.R.C. § 121(d).**

The amendment applies to sales or exchanges after the date of enactment. **Act Sec. 840(b).**

#### **Donations of motor vehicles, boats and airplanes**

The Act imposes limits on donated property, such as used automobiles (but also including boats and airplanes) with a

claimed value in excess of \$500 by requiring contemporaneous substantiation of value and providing that sale of the vehicle by the donee (without improvements or significant intervening use) limits the charitable deduction to the gross proceeds received from the sale. **Act Sec. 884(a), amending I.R.C. § 170(f)(12).** The provision is effective for contributions made after December 31, 2004. **Act Sec. 884(a).**

#### **Nonqualified deferred compensation plans**

The legislation provides new rules for requiring the inclusion of deferred compensation from nonqualified deferred compensation plans in gross income. **Act Sec. 885(a), enacting I.R.C. § 409A.** The provision is effective for amounts deferred after December 31, 2004. **Act Sec. 885(d).**

#### **User fees**

The authority to levy user fees is extended through September 30, 2014. **Act Sec. 891, amending I.R.C. § 7528(c).**

#### **Satisfaction of debt with partnership interest**

The Act specifies that cancellation of indebtedness income is realized on transfer of a capital or profits interest in a partnership to a creditor in satisfaction of recourse or nonrecourse indebtedness, based on the fair market value of the stock or interest. The amount recognized is the amount if the debt were satisfied with money equal to the fair market value of the partnership interest. **Act Sec. 896(a), amending I.R.C. § 108(e)(8).** The provision applies to cancellations of indebtedness occurring on or after the date of enactment. **Act Sec. 896(b).**

#### **Divisive, type D reorganizations**

The Act states that, in a reorganization under I.R.C. § 368(a)(1)(D), with respect to which stock or securities of the corporation are distributed in a transaction qualifying under I.R.C. § 355, the distribution is non-taxable only to the extent the sum of money and the fair market value of other property transferred to creditors does not exceed the adjusted bases of the property transferred. **Act Sec. 898(a), amending I.R.C. § 361(b)(3).**

#### **Controlled group of corporations**

The Act modifies the definition for “brother-sister” controlled groups to state that a brother-sister controlled group is two or more corporations if five or fewer persons who are individuals, estates or trusts own stock possessing at least 80 percent of the total combined power of all classes of stock entitled to vote, or at least 80 percent of the total value of shares of all classes of stock, of each corporation, and 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 shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each corporation. **Act Sec. 900(a), amending I.R.C. § 1563(a)(2).** The provision is effective for taxable years beginning after the date of enactment. **Act Sec. 900(c).**

#### **National Guard and Reserve Forces**

An amendment added to the American Jobs Creation Act of 2004 added several provisions under a separate bill, “Guardsmen and Reservists Financial Relief Act of 2004.” That legislation allows a penalty-free withdrawal from qualified retirement plans for individuals called to active duty for at least 179 days. **Act**

**Sec. 2(a), amending I.R.C. § 72(t)(2).** The provision is effective for individuals called or ordered to active duty after September 11, 2001, and before September 12, 2005. **Act Sec. 2(b).**

Under the Act, any differential wage payment is to be treated as a payment of wages by the employer to the employee with respect to any period during which the individual is performing service in the uniformed services while on active duty for more than 30 days. **Act Sec. 3(a), amending I.R.C. § 3401.** The effective date of this provision is for remuneration paid after December 31, 2004.

The Act also addresses differential wage payments in the context of eligibility to be treated as compensation such that the plan continues to be a qualified plan by reason of any contribution based on a differential wage payment. **Act Sec. 4(a), amending I.R.C. § 414(u).** This amendment applies to plan years beginning after December 31, 2004.

The legislation authorizes a “Ready Reserve-National Guard Credit” equal to 50 percent of the lesser of the actual compensation amount paid or \$30,000. **Act Sec. 5(a), adding I.R.C. § 45J.** The provision is effective for amounts paid or incurred after September 30, 2004, in taxable years ending after that date. Terminates for amounts paid or incurred after December 31, 2005. **Act Sec. 5(a), (a)(5), adding I.R.C. § 45J(e).**

The credit is claimable by a small business employer for a Ready Reserve-National Guard employee on any day when the employee is absent from employment for the purpose of performing qualified active duty. **Act Sec. 5(a), adding I.R.C. § 45J(b), (d).**

The legislation provides for a replacement employee credit hired to replace a Ready Reserve-National Guard employee of the taxpayer. **Act Sec. 5(b), amended by I.R.C. § 51(d)(1).** The provision is effective for amounts paid or incurred after September 30, 2004.

#### **Penalty-free withdrawals from retirement plans for victims of federally-declared disasters**

The Guardsmen and Reservists Financial Relief Act of 2004 specifies that distributions from retirement plans to victims of federally-declared natural disasters who have sustained a loss in excess of \$100 as a result of a major disaster under the Robert Stafford Disaster Relief and Emergency Assistance Act are exempt from premature withdrawal penalties if the distribution is made during the one-year period beginning on the date the declaration of emergency was made to the extent the distribution does not exceed the amount of the loss which is not compensated by insurance or otherwise. **Act Sec. 6(a), amending I.R.C. § 72(t)(2).** The provision is effective for distributions received in taxable years beginning after December 31, 2003. **Act Sec. 6(d).**