October 7, 2004

Highlights of the Conference Report to Accompany H.R. 4520, the American Job Creation Act of 2004

The Conference Report to H.R. 4520, H. Rept. 108-755, was filed on October 7, 2004.

NOTEWORTHY

- The Conference Report repeals the United States' current extraterritorial income (ETI) tax regime – which the World Trade Organization (WTO) has ruled is a prohibited export subsidy – and replaces it with a new tax deduction for domestic manufacturing.
- The Conference Report includes a number of provisions to reform and simplify current U.S. international tax rules, including improvements to the foreign-tax-credit rules and a one-year incentive for U.S. corporations to reinvest the earnings of their foreign corporations back into the United States.
- The Conference Report provides a variety of tax incentives for U.S. businesses, including small business, energy, and agricultural provisions. It also includes a new provision that permits taxpayers to elect to deduct their state and local sales taxes instead of an itemized deduction under present law for state and local income taxes.
- The Conference Report contains a variety of provisions to curtail tax shelters, improve corporate governance, and discourage expatriation.
- The Conference Report terminates the federal tobacco-quota and price-support programs, providing $10.14 billion in funding – entirely financed through assessments on tobacco companies – primarily to provide transitional assistance to current tobacco-quota owners and active growers.
- The Conference Report is estimated to be revenue neutral over 10 years.
- Once a conference report has been filed, it may be called up at any time. The motion to proceed to the conference report is privileged (i.e., it is not debatable). There is no time limit on debate of a conference report, except as agreed to by unanimous consent.

Background

Like many other countries, the United States has long provided benefits under its tax law to companies that export goods or services. For most of the last two decades, these benefits were provided to affected U.S. taxpayers under the Foreign Sales Corporation (FSC) tax regime. In 2000, the European Union succeeded in having the WTO declare the FSC tax regime a prohibited export subsidy.

In response to this WTO finding, the United States repealed the FSC rules and enacted a new tax regime, under the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. The European Union then immediately challenged the ETI tax regime, and in January of 2002, the WTO Appellate Body found that these rules also constituted a prohibited export subsidy under the relevant trade agreements.

The WTO has authorized the European Union to impose approximately $4 billion in tariffs on U.S. exports until the ETI tax regime is repealed. The European Union began phasing in retaliatory sanctions on March 1, 2004, and in October the sanctions amounted to 12 percent on certain classes of U.S. exports to European countries. The sanctions will continue to increase by 1 percent each month until the ETI tax rules are repealed.

Over the past two years, the Senate Finance Committee and House Ways and Means Committee have held hearings and developed legislation to repeal the ETI rules and provide replacement provisions to ensure that U.S. corporations can remain competitive in the global marketplace. In that regard, the House of Representatives on June 17, 2004 passed H.R. 4520, the American Jobs Creation Act of 2004, by a vote of 251 to 178. On July 15, 2004, the Senate substituted its Jumpstart Our Business Strength (JOBS) Act (S. 1637),[1] with an additional amendment concerning tobacco, into H.R. 4520, and passed the legislation by voice vote.

The Senate appointed the following 23 conferees on July 15, 2004: Senators Grassley, Hatch, Nickles, Lott, Snowe, Kyl, Thomas, Santorum, Smith, Bunning, McConnell, Gregg, Baucus, Rockefeller, Daschle, Breaux, Conrad, Graham (Florida), Jeffords, Bingaman, Lincoln, Kennedy, and Harkin. The House appointed the following 17 conferees on September 29, 2004: Congressmen Thomas, Crane, McCrery, Rangel, Levin, Goodlatte, Boehner, Stenholm, Johnson (Texas), Miller (California), Barton, Burr, Waxman, DeLay, Sensenbrenner, Smith (Texas), and Conyers.

A conference committee was convened on September 29, 2004, and the Conference Report, House Report 108-755, was filed on October 7, 2004.

[1] The Senate completed consideration of S. 1637 on May 11, 2004, approving the bill by a vote of 92 to 5.

Conference Report Provisions

Below is a summary of the major provisions of the Conference Report. A complete description of the provisions can be found in House Report 108-755. A copy of the Conference Report, the Statement of Managers, and a summary of the legislative provisions are available at: http://waysandmeans.house.gov/Special.asp?section=1570.

Repeal of the ETI Tax Regime and Establishment of a Deduction for Domestic Manufacturing

Repeal of the ETI Tax Regime

Under the current ETI tax regime, an exclusion from gross income applies with respect to certain types of income derived by a U.S. taxpayer from foreign trade, which is referred to as "extraterritorial income." This income generally relates to the export of goods and services by U.S. taxpayers, but also includes the lease or rental of qualifying property used outside the United States.

In order to bring U.S. tax laws into compliance with the country's WTO obligations, the Conference Report repeals the exclusion for extraterritorial income for transactions occurring after December 31, 2004. However, it also provides that the extraterritorial-income exclusion will remain in effect for transactions under binding contracts in effect on September 17, 2003.

The Conference Report provides a transitional rule for certain transactions currently covered by the ETI rules. Under this provision, only a limited amount of income (20 percent in 2005 and 40 percent in 2006) from such transactions will be subject to taxation. The transition rule expires after 2006.

Tax Deduction for American Manufacturers

Current law provides no deduction for domestic manufacturing activities other than permissible deductions for the costs associated with producing such income.

The Conference Report adopts the tax deduction for American manufacturers as included in the Senate version of H.R. 4520. This provision is intended to replace the tax relief currently received by American exporters under the existing ETI tax regime with a new deduction for domestic manufacturers. The new deduction applies to taxable corporations (C corporations) as well as certain pass-through entities (e.g., S corporations, partnerships, and trusts) and individuals.

The deduction is based on the business' "qualified production activities income." Such income is generally defined as the taxpayer's gross receipts from items manufactured, produced,

grown, or extracted by the taxpayer within the United States or its possessions, reduced by the sum of: (1) the cost of goods sold allocable to such gross receipts; (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, or losses that are not directly allocable to such receipts. Additionally, the Conference Report includes within the definition gross receipts derived from oil and gas extraction, utilities, construction, electricity, and certain film production, as adopted in the House version of the bill. The Conference Report also requires the Treasury Secretary to prescribe regulations governing the allocation of deductions, expenses, and losses to gross receipts.

The amount of the deduction is equal to the specific percentage (set out below) of the taxpayer's qualified production activities income (up to 50 percent of the wages paid by the business during the taxable year). As a result of the deduction, corporate taxpayers will see a reduction in their overall tax rate on their manufacturing income. Non-manufacturing corporations will continue to be subject to the existing maximum tax rate of 35 percent.

The following table reflects the effects of the new deduction on manufacturing income that is currently subject to the maximum 35-percent corporate-tax rate.

Taxable Year	2005-2006	2007-2009	2010 and later
Manufacturing Deduction Percentage	3%	6%	9%
Equivalent Manufacturing Tax-rate Reduction	1%	2%	3%
Resulting Tax Rate[2]	34%	33%	32%

The Conference Report also provides that taxpayers may claim the new deduction for purposes of the alternative minimum tax.

The new deduction for domestic manufacturers will be effective in taxable years ending after December 31, 2004.

Business, Agriculture, and Energy Provisions

Business Tax Incentives

The Conference Report includes a number of business tax provisions, many of which are drawn from the Senate version of the bill and complement the legislation's goal of providing tax benefits for American manufacturers. Key provisions in this section include:

[2] Figures assume income subject to the maximum 35-percent corporate-tax rate.

- An extension through 2007 of the section 179 expensing provision of the tax code, which permits small businesses to expense up to $100,000 of property placed in service (subject to a phase-out limitation of $400,000).

- A reduction in the depreciation-recovery period for leasehold improvements and certain restaurant properties from the current 39 years to 15 years, applicable to property placed in service before January 1, 2006.

- A package of provisions to reform and simplify the tax rules pertaining to S corporations, including an increase in the number of eligible shareholders from 75 to 100 and modifications to the rules relating to S corporation banks, subsidiaries, and trusts.

Energy Tax Provisions

While the Conference Report does not include the energy title from the Senate version of H.R. 4520, it does include several sections relating to energy, including:

- Provisions relating to the Volumetric Ethanol Excise Tax Credit (VEETC) for certain alcohol and biodiesel fuels.

- An income tax credit for the production of low-sulfur diesel fuel.

- Expansion of the tax credit for electricity produced from certain renewable resources to include open-loop biomass, geothermal energy, solar energy, small irrigation power, and municipal solid waste.

- Application of the tax credits for alcohol fuels and electricity from certain renewable resources for purposes of calculating the alternative minimum tax.

- Creation of a 7-year depreciation-recovery period for the Alaska natural gas pipeline (rather than the 15-year recovery period under current law).

- Expansion of the oil-recovery tax credit for certain natural-gas processing plants.

Agricultural Tax Relief and Incentives

Drawing from both the Senate and House versions of H.R. 4520, the Conference Report includes several provisions relating to agricultural businesses, including:

- Expansion of the current rule that allows income to be deferred on livestock sold due to drought, flood, or other weather-related conditions, provided that such livestock is replaced within four years (rather than two years under current law).

- Inclusion of individuals engaged in the business of fishing under the farm income-averaging rules, and coordination of such rules with the alternative minimum tax to ensure that individuals utilizing income-averaging receive the full benefit.

- Tax relief for timber businesses including capital-gains treatment for outright sales of timber, expensing of up to $10,000 in reforestation expenditures (rather than amortizing such costs over 7 years as required under current law), and an election to treat timber as a sale or exchange.

International Tax Provisions Relating to U.S. Businesses

The Conference Report includes a host of provisions intended to reform and simplify the current U.S. international tax rules. The majority of these provisions focus on improving the foreign-tax-credit rules, which are designed to reduce the double taxation of income for companies operating abroad. A significant benefit of these changes will be to reduce the tax burden on U.S. multinational corporations, leaving them with additional capital for reinvestment and job creation. Key provisions in this portion of the Conference Report include:

- Modification of the interest-allocation rules to permit the allocation of interest expenses of the domestic members of a multinational corporate group on a worldwide basis, thereby increasing the group's potential foreign-tax credit.
- Expansion of the foreign-tax-credit carryforward period from five years to ten years and reduction of the carryback period from two years to one year. The Conference Report also includes the House provision that removes current-law restrictions on corporations' ability to use foreign-tax credits across different lines of business (i.e., reducing the current foreign-tax-credit "baskets" from nine to two – one relating to general business activities and the other to passive activities).
- Repeal of the current 90-percent limitation on the use of foreign-tax credits when calculating the alternative minimum tax.
- A one-year incentive for U.S. corporations to reinvest the earnings of their controlled foreign corporations back into the United States, by applying a reduced maximum tax rate of 5.25 percent on dividends repatriating such earnings. The reduced tax rate applies, at the corporate taxpayer's election, to dividends received during the tax year beginning on or after the date of enactment of this legislation or the last tax year beginning before the date of enactment. The Conference Report provides various limitations on the dividends that qualify for the special, reduced tax rate to prevent abuse of this provision.

Deduction of State and Local Sales Taxes

The Conference Report includes a provision from the House version of H.R. 4520 that permits taxpayers to deduct their state and local sales taxes in lieu of an itemized deduction under present law for state and local income taxes. This provision is designed to provide more equivalent federal tax treatment for taxpayers living in states that impose only a sales tax – as opposed to those taxpayers subject to state or local income taxes.

Taxpayers would generally have two options for determining the amount of their sales tax deduction: (1) the taxpayer may deduct the total amount of state and local sales taxes actually paid by accumulating receipts reflecting the taxes; or (2) the taxpayer may use tables provided by the Treasury Department, which will reflect the average sales taxes paid by individuals on a state-by-state basis (taking into account filing status, number of dependents, adjusted gross income, and applicable state and local tax rates).

Taxpayers who use the sales tax tables may, in addition to the table amount, deduct certain sales taxes paid with respect to the purchase of motor vehicles, boats, and other items specified by the Treasury Department.

The deduction for state and local sales taxes is applicable to taxable years 2004 and 2005.

Revenue Provisions

In addition to the revenue resulting from the repeal of the ETI tax regime, the Conference Report includes a variety of provisions that raise additional revenues. In general, these provisions are intended to curtail tax shelters, improve corporate governance, and discourage expatriation. Key provisions in the Conference Report include:

- New rules to discourage U.S. multinational corporations from moving their headquarters offshore to take advantage of lower-tax jurisdictions (i.e., so-called "corporate inversions"). These rules generally apply to inversion transactions that occur after March 4, 2003.
- Improved rules for determining whether individuals are relinquishing their U.S. citizenship (i.e., expatriating) in order to avoid U.S. taxation, and modification of existing provisions that subject such expatriates to U.S. taxes in certain cases.
- Increased penalties with respect to tax shelters as well as listed and reportable transactions. The Conference Report also provides the Treasury Department with additional enforcement tools to combat tax-shelter and other abusive transactions.
- Limitations on the tax benefits arising from certain leasing transactions involving tax-exempt entities (i.e., so-called "sale-in/lease-out" or SILO transactions). These limitations generally apply to leases entered into after March 12, 2004.
- Provisions to reduce the occurrence of fuel-tax fraud and abuse through enhanced enforcement and penalties.
- Authorization for the Treasury Department to enter into contracts with private collection agencies to perform certain services with respect to the collection of unpaid taxes.
- Extension of Internal Revenue Service and Customs user fees through 2014.

Elimination of Tobacco Quotas

Based on sections from both the Senate and House versions of H.R. 4520, the Conference Report includes provisions to terminate the federal tobacco-quota and price-support programs. Beginning with the 2005 tobacco crop, the Conference Report provides that current quantity or geographic growing restrictions and price supports will no longer apply. In their place, the Conference Report provides $9.6 billion in total compensation and transition payments to tobacco-quota owners and active growers, with an additional $500 million to compensate the Department of Agriculture (USDA) to cover any losses relating to disposal of pool stocks (i.e., stocks bought by cooperatives with federal loans and no-net cost funds).

The total cost of the buyout is approximately $10.14 billion. The payments will be made as follows:

- Quota owners who, as of the date of enactment of this legislation, owned a basic tobacco marketing quota or allotment for the 2004 marketing year will be paid $7 per pound for the basic quota they owned in 2002.
- Active tobacco producers (i.e., they shared in the risk of producing tobacco) will be paid $3 per pound for their 2002 effective quota with the following stipulations:
  - Active producers participating in all three marketing years – 2002, 2003, and 2004 – will receive the full grower payment ($3 per pound times the 2002 effective quota);
  - Active producers participating in two of the three marketing years will receive two-thirds of the full grower payment ($2 per pound times the 2002 effective quota); and
  - Active producers participating in one of the three marketing years will receive one-third of the full grower payment ($1 per pound times the 2002 effective quota).

The quota-owner and grower payments will be spread equally over 10 years, 2005 through 2014, but the Conference Report does allow quota-owner and grower contract payments to be made directly to financial institutions in order to provide an option for the quota owner or grower to sell the stream of 10-year payments for a discounted lump sum.

In keeping with the Senate version of H.R. 4520, the tobacco buyout is funded by quarterly assessments on tobacco-product manufacturers and importers. Since the buyout is funded though assessments on tobacco companies, future payments from the 1998 Master Settlement Agreement (i.e., Phase II payments), under which cigarette manufacturers agreed to distribute $5.15 billion to tobacco producers and quota owners over a 12-year period, will be terminated.

Cost

The Joint Committee on Taxation estimates that the provisions of the Conference Report are revenue neutral over 10 years. A copy of the revenue estimate is available at: http://www.house.gov/jct/x-69-04.pdf.