



# Tax Trends

By Mark A. Luscombe

## Year-End Issues Arising from New Tax Legislation

Many tax practitioners will be trying to absorb the intricacies of the American Jobs Creation Act of 2004<sup>1</sup> for many months to come. Yet, some of the provisions have created some planning opportunities that should be addressed with clients before year-end.

### Manufacturing Deduction

The new manufacturing deduction will apply to a broad range of businesses. All it requires is that there be activity of manufacturing, producing, growing or extracting in whole or in substantial part within the United States. Such businesses will be trying to determine what part of their business activities constitute "qualified production activities income" and to what extent they have "qualified production property." Although the manufacturing deduction is not effective until January 1, 2005, many businesses will want to make sure that they understand how the new deduction applies to them so that they can be ready on January 1, 2005, to take maximum advantage of the deduction. Such reviews could include the amount of U.S. processing that goes into a final product; the level of W-2 wages to avoid any problem with the statutory limit on the deduction to 50 percent of W-2 wages; and to what extent deferral of certain activities until next year in order to take advantage of the new deduction would make sense.

Unfortunately, many businesses will find that they are left with more questions than answers after a review of this new provision. The Treasury anticipates that providing guidance on this new provision will be time consuming and the resulting guidance complex. There may be some analogies in existing Code provisions that could provide some clues, but until the IRS officially sanctions such reliance, taxpayers may feel uncomfortable acting too precipitously. Still, tax practitioners will want to educate their clients as much as possible prior to year-end as to what is known as well as what is unknown so that their clients can be as prepared as possible for the new deduction's arrival on January 1st.

### Nonqualified Deferred Compensation

The new law changes in several significant respects

what constitutes a substantial risk of forfeiture for purposes of determining what qualifies as nonqualified deferred compensation. Most commentators seem to feel that the majority of deferred compensation plans in existence will in some way fall afoul of the new requirements. The new law includes a list of criteria to which a distribution must be tied. These include separation from service, death, disability, a specified time, change in ownership or control, or an unforeseen emergency. The law provides a set of guidelines for the required timing of a deferral election, in general requiring that the election be made before the employee earns the deferred compensation. The new guidelines also generally prohibit the acceleration of deferred payments. A set of funding rules are included that basically prohibit deferral through offshore trusts. Failure to comply with the new rules results in immediate taxation of the deferred income, interest going back to the point at which the income should have been originally reported, and a 20-percent penalty.

Although the new rules apply only to amounts deferred after December 31, 2004, if a deferred compensation plan is materially modified after October 3, 2004, amounts previously deferred under the plan will become subject to the new rules. The IRS has been directed to issue guidance on this new provision within 60 days of enactment, *i.e.*, December 21, 2004. Although tax practitioners should start immediately to review with their clients existing deferred compensation plans to determine if they meet the new criteria, those plans should not be amended until IRS guidance comes out, since those amendments could end up destroying the grandfathered status of prior deferred compensation in those plans. If clients want to make any changes in deferred compensation before year-end and before IRS guidance is promulgated, those clients should consider using a new deferred compensation plan that would not endanger the status of existing plans.

Mark A. Luscombe, J.D., LL.M., CPA, is a Principal Analyst for  
Federal Tax at CCH INCORPORATED.

### Depreciation

Bonus depreciation generally expires at the end of 2004 and was not extended by the new tax laws. Nor is the Administration likely to consider a retroactive extension in 2005. Clients seeking to take advantage of bonus depreciation should therefore make capital acquisitions before year-end. Property with an extended construction or development period does still qualify for bonus depreciation into 2005, and the new legislation extended this extended construction provision to cover certain private aircraft.

The new fifteen-year recovery period for qualified leasehold improvements and qualified restaurant property applies to property placed in service after October 22, 2004, so it is available for year-end improvements. Keep in mind that the new 15-year recovery period expires on December 31, 2005, although this may become another of those regularly expiring provisions that Congress eventually seems to find the will to extend, even if retroactively.

The new \$25,000 limit on first year expensing under Code Sec. 179 of vehicles weighing between 6,000 and 14,000 pounds was effective as of October 23, 2004. However, practitioners should note that the \$25,000 limit is still more attractive than the Code Sec. 280F luxury automobile depreciation limits that apply to vehicles weighing 6,000 pounds or less. Also, with bonus depreciation still available through the end of 2004, there are still considerable tax advantages to buying a heavy SUV before the end of 2004.

### Vehicle Donations

The new rules restricting the charitable deduction for a donated vehicle to the gross sales price obtained by the donee charity on a written acknowledgement form apply to donations after December 31, 2004. Excepted from the gross sales price rule are donations valued at \$500 or less, or vehicles significantly modified by or retained by the charity. Taxpayers that feel that the gross sales price obtained by the charity is likely to be at the low end of the fair market value of their vehicles may want to consider making the donation before year-end and before the new rules take effect. Taxpayers may in the future be much more interested in examining the sales procedures used

by the charity to obtain the highest possible price for the vehicle or looking for charities that tend to use the vehicles in fulfilling their exempt purposes.

### Sales Tax Deduction

The new election to deduct either state and local sales taxes or state and local income taxes as an itemized deduction is effective for 2004 and 2005. Although the new law gives the taxpayer a choice of using either actual receipts or IRS tables, many taxpayers for 2004 will have already disposed of receipts for the first three-quarters of the year and may be stuck with the tables. The IRS hopes to have the new tables published by the end of 2004. Tax practitioners will now have several steps to review with their clients in evaluating this new deduction: Is it better to use the tables or actual receipts, is it better to deduct sales taxes or income taxes, and is it better to itemize or take the standard deduction? Remember also that itemized deduction phase-outs or the alternative minimum tax could limit the value of this new deduction. Although most beneficial to taxpayers in states that do not impose an income tax and do impose a sales tax, many taxpayers in states with both income and sales taxes may find that it is worthwhile to maintain records and run the numbers to see whether the sales tax deduction or the income tax deduction is more valuable to them in any particular year. The sales tax deduction is also an item that may be easier for many taxpayers to manipulate by placing more big ticket purchases into a year when they intend to itemize to increase the level of itemized deductions and avoid big ticket purchases in years when they intend to claim the standard deduction.

### Summary

There are a variety of provisions in the new tax legislation that warrant a careful review by tax practitioners with their clients. In addition to the provisions of relatively broad application discussed here, there are a very large number of more focused provisions included in the legislation that could be very significant to particular taxpayers or particular industries in terms of year-end planning.

### ENDNOTES

<sup>1</sup> American Jobs Creation Act of 2004 (PL. 108-357).

This article is reprinted with the publisher's permission from the TAXES—THE TAX MAGAZINE, a monthly journal published by CCH INCORPORATED. Copying or distribution without the publisher's permission is prohibited. To subscribe to the TAXES—THE TAX MAGAZINE or other CCH Journals please call 800-449-8114 or visit [www.tax.cchgroup.com](http://www.tax.cchgroup.com). All views expressed in the articles and columns are those of the author and not necessarily those of CCH INCORPORATED or any other person.