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# 2004 Tax Legislation

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## 2004 TAX LEGISLATION

- The Working Families Tax Relief Act of 2004
- The American Jobs Creation Act of 2004

Congress recently approved, and President Bush has signed, two tax bills that make significant changes to the Internal Revenue Code. Generally, the *Working Families Tax Relief Act* extends several expiring provisions that benefit businesses and individuals. The *American Jobs Creation Act* repealed the Extraterritorial Income provisions and replaced them with a deduction for income from production activities and made other far-reaching changes that affect a broad range of businesses and industries, and many individual taxpayers.

### INTERNATIONAL PROVISIONS

The American Jobs Creation Act ("AJCA") makes significant changes in the taxation of US taxpayers with international operations. Highlights include:

#### One – Time 85% Deduction for Dividends Received from a CFC

- The AJCA adds new IRC § 965 providing for a deduction of 85% of cash dividends received from a CFC.
- Limited to "extraordinary" cash dividends, and subject to other limitations.
- Available for only one taxable year, as elected by the taxpayer.
- Dividends must be re-invested in the US.
- No foreign tax credit available with respect to the amount of the dividend.

#### Foreign Tax Credit Changes

- Several separate income "baskets" are eliminated (including passive income, financial services income, shipping income, foreign trade income), leaving only two "baskets" – passive and general income.
- The AJCA provides a one-time election to allocate interest expense of the domestic members on a world-wide basis, rather than solely among the US affiliated group members.
- Current law provides that the "AMT foreign tax credit" may offset only 90% of the AMT liability. The 90% limitation is repealed.
- Under the AJCA, if a US source loss is used to offset foreign source income, thereby reducing the foreign tax credit limitation, a portion of the US source income in future years is recharacterized as foreign source income.
- Dividends from § 902 corporations attributable to pre-2003 earnings are no longer included in a separate "basket" for purposes of the foreign tax credit limitation, but are allocated among the other "baskets" in proportion to the earnings and profits attributable to the other income in those baskets.
- Stock owned by a partnership is treated as being owned proportionately by its partners for purposes of § 902.
- The AJCA establishes a 10-year carryover and 1-year carryback for FTCs.

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## Changes to Subpart F Rules

- Under current law, US shareholders of a controlled foreign corporation are required to take into account their pro-rata share of the CFC's earnings that are invested in "US property." The AJCA excludes from the definition of US property under IRC § 956 both (i) securities acquired by the CFC in the ordinary course of its trade or business, and (ii) an obligation of a US person that is not a corporation and is not related to the CFC.
- The AJCA repeals the separate anti-deferral rules relating to foreign personal holding companies (IRC §§ 551-558) and foreign investment companies (IRC §§ 1246-1247). Subpart F continues to include "foreign personal holding company income" in Subpart F income.
- Under current law, the term "US property" under IRC § 956 excludes "deposits with persons carrying on the banking business." The AJCA defines the term "banking business" to overturn a broader definition applied in a recent court decision.
- In determining a CFC's Subpart F income under current law, gain from the sale of a partnership interest is generally treated as passive income. Under the AJCA, the sale of certain partnership interests is treated as the sale of a proportionate share of the partnership's assets.

## Anti-Expatriation Provisions

- The AJCA attacks "inversion" transactions, under which some US corporations have reorganized under the laws of a foreign jurisdiction. Generally, if the shareholders of an "inverted" US corporation own at least 80% of the stock of the foreign corporation, the corporation continues to be treated as a US corporation, subject to US corporate income tax. If the shareholders own between 60% and 80% of the foreign corporation, the US corporation is taxable on the "inversion gain" but cannot use its tax attributes (i.e. NOLs and foreign tax credits) to reduce the tax. Similar rules apply to partnership inversions. The new rules are effective for inversions occurring after March 4, 2003.
- The AJCA imposes an excise tax, at the maximum net capital gains rate, on the value of stock compensation of insiders of any US corporation that implements an inversion transaction, and denies a compensation deduction to the corporation. The tax is imposed only if a shareholder is required to recognize gain on the inversion transaction, and applies to persons who have reporting obligations under SEC regulations (or would have such obligations if the corporation were a reporting company).

Please contact one of the members of our Federal Income Tax Group listed on page one for further information on the new legislation.

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