November 12, 2004

State and Local Side Effects of the American Jobs Creation Act

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On October 22, 2004, President George W. Bush signed the American Jobs Creation Act of 2004 ("AJCA"). This act was originally conceived as the vehicle for repealing a federal income tax exclusion afforded for certain extraterritorial income ("ETI").[1] The ETI provision had been held by the World Trade Organization to constitute a prohibited export subsidy, resulting in the imposition of tariffs against U.S. products, a problem that clearly required corrective federal legislation.[2] As AJCA made its way through Congress, however, it became much more than a "fix" for the ETI problem. Instead, it acquired numerous amendments, and emerged as complex, wide-ranging legislation.

Much is being written about the federal significance of AJCA. This article, however, limits itself to the state and local tax ramifications of the federal changes. There are a variety of aspects of AJCA that do not impact state and local taxation at all -- for example, the changes to the foreign tax credit provisions generally have no state or local counterpart. There are, however, a number of provisions in AJCA that are directly relevant to state and local tax planning, or that may foreshadow state and local efforts to "decouple" the computation of such taxes from the new federal rules.

Focal Point

As the centerpiece of the AJCA, the ETI regime has been replaced with a general deduction for "income attributable to domestic production activities."[3] This new deduction is allowed to manufacturers and certain other taxpayers, and, essentially, allows qualified persons to reduce the amount of net income subject to federal income tax. The deduction starts at 3% for 2005, and grows to 9% in 2010.

To oversimplify, new code section 199 allows a federal income tax deduction of up to 9% of the net income that is derived from the: (i) sale, lease, etc. of qualified property manufactured in the United States; (ii) construction that is performed in the United States; and (iii) engineering and architectural services performed for projects located in the United States. In each case, however, the deduction cannot exceed 50% of the W-2 wages paid by the taxpayer in the year.

By repealing the ETI, AJCA increased the tax base of exporters. This creates a larger tax base for states and localities as well, a change to which they clearly are likely to conform. However, new §199 decreases the tax base by creating a new deduction for qualified taxpayers, whether they are corporations, partnerships or individuals. From a state and local tax perspective, the question is whether states and communities likewise will allow this new deduction, and suffer the concomitant reduction in their tax base.

In the first instance, states which premise their calculation of taxable net income on federal net income will, absent a specific change to state income tax laws, automatically conform to the new §199 deduction. However, as was the case with the generous "bonus depreciation" enacted by Congress in the wake of September 11, states and localities sometimes find that they cannot afford the costs of new federal tax incentives. In the case of bonus depreciation, numerous states enacted legislation that decoupled the computation of state depreciation deductions from the federal allowances of bonus depreciation and tied state depreciation deductions to the "old" federal depreciation rules.

As compared to bonus depreciation, the costs of the deduction for manufacturers and others may be more difficult for states to measure. The new §199 deduction is a deduction in respect of the net profits of certain specific kinds of activities, and it is limited by the W-2 payroll limitation. With the initial deduction set at only 3%, states may wait to see what new these deductions look like before they can evaluate the effects of new §199 on state and local revenues.

Single-Factor Apportionment

Further complicating the analysis, the new §199 deduction targets an activity -- manufacturing -- which many states already incentivize through favorable tax rules, such as location-specific incentive programs, investment tax credits and favorable sourcing rules. As one example of this phenomenon, which continues to develop and change around the country, New York Governor George Pataki included in his 2004-2005 budget a proposal that would have allowed manufacturers to apportion their income to New York based solely on the location of their customers. This "single-factor apportionment" is viewed as a means to encourage New York-based manufacturing by eliminating the in-state allocation of income that currently results from increases in the number of manufacturers' New York-based plants or the size of payrolls.

Single-factor apportionment for manufacturers was not enacted in the 2004 New York State budget, in part due to resistance raised by other business sectors (e.g., financial services) which were not offered similar benefits. If New York State simply conforms to the new federal legislation, however, the effect will be that manufacturers, perhaps unexpectedly, receive a 3% - 9% New York deduction as well. As a result, manufacturers will be taxed, for federal, state and local purposes, at a lower rate than other businesses. Whether that lower rate resembles in any way the relief sought through, for example, single-factor apportionment or whether it resembles in any way the revenue cost of such a proposal -- or of other incentives -- is unknown. What is clear at this point is that this new §199 deduction has been inserted into the middle of an ongoing state tax policy discussion, with potentially interesting side effects.

The question of whether states might decouple from new federal tax benefits arises in a few other contexts under AJCA as well. The federal legislation included a 15-year write-off period for "qualified leasehold improvement property" and "qualified restaurant property," if placed in service between October 22, 2004 and January 1, 2006.[4] It also allows 15-year amortization of sports franchises[5] and imposes a 15-year amortization period for start-up expenditures.[6] While obviously narrower in scope, and to an extent only temporary, these provisions offer additional examples of federal tax changes that, absent decoupling legislation, will produce state and local benefits as well.

AJCA also provides a new deduction for certain costs of qualified film and television productions. Interestingly, this comes on the heels of New York State tax legislation making $25 million in tax credits available to the film industry. Again, therefore, we see new federal benefits for an industry that has also been targeted for state benefits. Whether the cumulativeness of benefits was anticipated, or will stand, remains to be seen.

A completely different but quite interesting feature of AJCA is its allowance of a new federal income tax deduction for state and local sales taxes.[7] In 1986, the itemized deduction for sales taxes was repealed, leaving deductions for only state and local income taxes and property taxes.[8] In a number of states,[9] however, there is no state personal income tax, and instead, these states rely more heavily on state and local sales taxes to raise revenues.[10] Residents of such sales-tax states were disadvantaged vis-à-vis their neighbors in income-tax states, because the income tax payers were afforded federal deductions, while the sales tax payers were not.

Enter new §164(b)(5), which provides a federal election, for 2004 and 2005 under which taxpayers can choose to deduct state and local "general sales taxes" in lieu of deducting state and local income taxes. AJCA authorizes the promulgation of tables that taxpayers can use in determining their sales and use tax deduction (presumably in lieu of precise record-keeping); for certain major purchases (boats, cars) the sales tax could be deducted in addition to the table amounts.

In explaining this change, Congress stated that "the provision of an itemized deduction for state and local general sales taxes in lieu of the deduction for state and local income taxes provides more equitable Federal tax treatment across states and will cause the Federal tax laws to have a more neutral effect on the types of taxes that State and local governments utilize."[11]

For individuals who pay New York income tax, the new sales tax deduction may not be particularly meaningful. With state personal income taxes at 7.7% and city resident tax at 4.45%, New York taxes on net income will in almost all cases exceed the New York sales taxes on consumption.[12] However, there may be situations in which that assumption is not accurate -- taxpayers with low taxable income, for example, or with disproportionate sales tax payments made in 2004 or 2005. Accordingly, while not targeted to states like New York, the new sales tax deduction may nevertheless merit consideration in some situations. Note also that, pending legislation conforming state income taxes to this new federal itemized deduction, there may be instances in which the amount of state taxable income will be determined by taking the federal *sales* tax deduction into account, whereas federal deductions for state *income* taxes would not be allowed as state itemized deductions.[13]

AJCA also loosened considerably the S corporation rules, making more corporations eligible for S corporation status. This generally is good news and serves as well as a useful reminder that corporations doing business in New York must specifically elect state S corporation status and that New York City does not recognize S status at all.

In addition to benefits, AJCA also included provisions targeted to close down certain transactions that Congress considered troublesome. "Inversion" transactions, in which a company (such as Tyco) moves offshore to save taxes, have vexed taxwriters for some years now. AJCA seeks to curtail this activity by denying the use of accumulated losses (and similar tax attributes) to shelter inversion-triggered gains[14] and, in certain cases, by deeming the resulting foreign parent to be a domestic corporation.[15] Depending on the state net operating loss picture, the denial of shelter may or may not affect state taxes; the denial of federal credits may not be relevant at all where there is no counterpart state credit.

More interesting is the notion that "a foreign corporation shall be treated for purposes of this title as a domestic corporation. . . ."[16] Does this confer authority on states and localities to disregard the entity's foreign status as well? If so, where is such a corporation deemed to have been incorporated? Can it join in the filing of combined state corporate reports?

Two other tax-shelter-driven provisions in AJCA are noteworthy. A variety of structures have been utilized of late essentially to enable one taxpayer to transfer a "built-in loss" to another taxpayer, frequently through the contribution of loss property to a partnership or corporation. ACJA seeks to curtail these transactions: (i) by requiring allocations of built-in losses to the contributing partner;[17] (ii) by requiring partnership basis adjustments that step down the basis in loss assets following a sale[18] or distribution;[19] and (iii) by requiring that the basis of certain property contributed to a corporation not exceed its fair market value.[20] However, the mandated step-down in partnership asset basis does not apply to certain electing investment partnerships;[21] instead, the election results in loss limitation at the partner level. And in the case of transfers to corporations, instead of reducing the transferee's basis for the built-in loss property, the parties can elect to reduce the transferor's stock basis.[22]

For the most part the AJCA provisions will operate at the state and local level in much the same way as the federal. However, in the corporate context, the election to reduce stock basis could produce a dramatically different result than reducing asset basis. In New York State, for example, general business corporations do not pay tax on gains from subsidiary stock[23] and nonresidents do not pay tax on gains from intangibles.[24] In some circumstances, therefore, an otherwise fairly neutral federal choice can be significant to state and local taxes.

Finally, AJCA included significant new restrictions on executive compensation, particularly nonqualified deferred compensation. These amendments will make it more difficult to implement such compensation plans, which will have the ancillary effect of reducing taxpayers' abilities to achieve some state tax savings through deferred compensation arrangements.

Numerous other tax law changes were included in AJCA. There are, for example, many important changes in the foreign area, including changes relating to expatriates, foreign tax credits, interest allocation rules, foreign personal holding companies, and the repatriation of corporate earnings. There are changes in the expensing allowed under §179, in particular cut-backs in the generous rules formerly applied to sports utility vehicles. There also are significant new tax shelter enforcement provisions, including new penalties on advisors. AJCA also included a veritable shopping cart of narrowly targeted tax breaks, for example, reductions in the excise taxes on imported ceiling fans, on tackle boxes, and on fish finders (those boat-borne boxes humans use to find the ones that used to get away).

Conclusion

We have highlighted here only those elements of this complex legislation that, in our unique, multilayered tax system that have (or may have) particularly interesting state tax side effects, both to alert the reader to substantive federal-state differences, and to illustrate some of the complications of federalism that are often not well considered in the tax legislative process.

[1] IRC §114.

[2] ETI replaced the Foreign Sales Corporations ("FSCs"), that previously were ruled illegal subsidies; FSC's, in turn, replaced Domestic International Sales Corporations (DISCs"), similarly ruled illegal.

[3] IRC §199.

[4] IRC §168(e)(3)(E). The 15-year period applies to certain gas utility land improvements as well.

[5] Repeal of former IRC §197(e)(6), effective for property acquired after October 22, 2004.

[6] IRC §195(b)(1), effective for amounts paid after October 22, 2004.

[7] IRC §164(b)(5).

[8] IRC §164(a).

[9] For example, Florida, Washington, Texas, Tennessee, Wyoming, South Dakota and Nevada.

[10] Commentary on the regressive nature of such a tax system is beyond the scope of this article.

[11] H. Rep. §501.

[12] AJCA made some small changes to the alternative minimum tax. Unfortunately, it did not address the significant and growing problem of the disallowance of deductions for state income taxes in computing the AMT, a problem that was discussed in this column last December.

[13] See, for example, N.Y. Tax Law §615(c)(1), defining New York itemized deductions by reference to the federal, but adding back "income taxes imposed by this state . . . ."

[14] IRC §7874, effective for tax years ending after March 4, 2003.
[15] Id.
[16] Id.
[17] IRC §704(c)(1)(C).
[18] IRC §743(a), (d).
[19] IRC §743(a), (d).
[20] IRC §362(e).
[21] IRC §743(e).
[22] IRC §362(e)(2)(C).
[23] N.Y. Tax Law §208(9)(a)(1).
[24] N.Y. Tax Law §631(b)(2).