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How will the American Jobs Creation Act of 2004 affect state taxes?

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American Jobs Creation Act of 2004

- **Most significant business tax legislation since Tax Reform Act of 1986**
  - Changes the tax rules in every major substantive area of the Code
  - More than 170 tax provisions
  - “Size” of tax bill -- roughly $137 billion over 10 years
    - However, the Act is “revenue neutral” – tax reductions are offset by tax increases or reductions in outlays

American Jobs Creation Act of 2004 Act: Summary of Key Provisions

- Manufacturing deduction
- Repatriation incentive

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IRC § 199: Income Attributable to Domestic Production Activities

Section 199 Overview

- **Replacement for FSC/ETI regimes**
- **Provides a deduction equal to a percentage of the lesser of:**
  - Qualified production activities income (QPAI) of the taxpayer for the tax year, or
  - The taxpayer's taxable income for the tax year
- **Eligible percentage of qualified production activities income is:**
  - 3% for tax years beginning in 2005 and 2006
  - 6% for tax years beginning in 2007 through 2009
  - 9% for tax years beginning in 2010 and later
- **Limited to 50% of W-2 wages**

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Section 199 Overview Continued - Qualified Production Activities Income (QPAI)

QPAI* = DPGR, minus the sum of:**

(i) Allocable CGS;

(ii) Other directly allocable deductions, expenses, losses;

(iii) Ratable portion of other deductions, expenses, losses***

*** Qualified production activities income**

**** Domestic production gross receipts**

***** Except those allocable to another class of income**

Expanded Affiliated Group (EAG) = Single Taxpayer

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State Tax Implications of IRC § 199

- **States have a long history of rewarding manufacturing and production activities**
  - Income tax credits
  - Special apportionment factors
  - Sales, use and property tax exemptions
- **Will states that already provide benefits also honor IRC § 199 benefit by inclusion in state tax base?**

State Tax Implications of IRC § 199

- **Conformity to date**
  - Decoupled: 6 states
  - Adopted: 7 states
  - Numerous provisions that would adopt and decouple still pending or awaiting signature
- **Conformity is actually a two-part inquiry**
  - Will a state conform?
  - How will the state conform?

State Tax Implications of IRC § 199

- **What is manufacturing?**
  - In some respects, the § 199 definition is much broader than comparable state tax definitions
    - Construction, engineering, architectural services
    - Software, sound recordings and films
  - In other respects, the § 199 definition is narrower that comparable state tax definitions
    - In-store bakeries and restaurant food preparation equipment qualify for sales tax exemptions in some states

State Tax Implications of IRC § 199

- **Recordkeeping and administration**
  - Inconsistencies between state and federal definitions of manufacturing/production could require multiple layers of computation and records
  - Additional recordkeeping complexities if states decouple inconsistently
    - Dollar or percentage caps
    - Uneven adoption of “expanded affiliated group”

State Tax Implications of IRC § 199

- **Expanded affiliated group**
  - In other areas of state tax law, separate reporting states have rejected consolidated return concepts
  - Some states may require calculation to be made "as if each taxpayer was **not** a member of an expanded affiliated group"
  - Partnerships and LLCs treated as partnerships are **not** members of the expanded affiliated group

State Tax Implications of IRC § 199

- **Calculation**
  - Deduction allocated to separate entities will usually be proportional to each entity's share of QPAI
  - However, because benefit is tied to profitability, not investment, allocation could disadvantage entities that incur significant production related expenses
  - Will states adopt the federal methodology?

State Tax Implications of IRC § 199

- Example: Single state entities; Co. A makes significant investment in production facilities

	Company A State X	Company B State Y	Total
Production Gross Receipts	$10,000	$5,000	$15,000
Cost of Goods Sold	$11,000	$1,000	$12,000
QPAI	$(1,000)	$4,000	$ 3,000
3% Deduction	0	$ 90	$ 90

Example: Single State Entities; Company A and Company B Are Not Unitary

	Company A State X	Company B State Y	Total
Domestic Production Gross Receipts	$10,000	$10,000	$20,000
COGS	$ 5,000	$ 5,000	$10,000
QPAI	$ 5,000	$ 5,000	$10,000
Taxable Income	$ 1,000	$ 5,000	$ 6,000
Deduction	--	--	$ 180
Allocation of Deduction	$ 90	$ 90	$ 180

State Tax Implications of IRC § 199

- **Constitutional considerations**
  - Would reduction of state tax base via incorporation of IRC § 199 *domestic* production benefit violate the foreign commerce clause?
  - Blind conformity does not justify discrimination (*Kraft*)
  - Lack of corresponding state benefit does not justify discrimination (*Kraft*)

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State Tax Implication of IRC §199

- **Recap of Issues**
  - Separate or Expanded Affiliate Calculation
  - State Modifications (e.g., depreciation)
  - Separate Accounting
  - Definition of Manufacturing
  - Consolidated and Combined Return States
  - Constitutional Issues – *Kraft*
  - Non-Unitary Affiliates
  - Entity Classification Issues

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Repatriation Incentive: Temporary Dividends Received Deduction

New Code Section 965

Repatriation Incentive: Temporary Dividends Received Deduction

- ***General Rule:*** **For a limited time, a U.S. corporate shareholder is eligible for an 85% DRD on certain cash dividends from CFCs**
- ***Time Limit:*** **The DRD is available for qualifying dividends paid either during the taxpayer's:**
  - Last tax year beginning before October 22, 2004, or
  - First tax year which begins during the one-year period beginning on October 22, 2004
- ***Timing of Election:*** **Must be made before the due date (including extensions) for filing the return for the applicable tax year**

Repatriation Incentive: Temporary Dividends Received Deduction

- **Ceiling limitations**
- **Must be an "*extraordinary dividend*"**
- **Reduction of benefit for related-party indebtedness**
- **Dividends must be invested in the U.S. *pursuant to* a "domestic reinvestment plan"**
  - Plan must be approved by the taxpayer's president, CEO or comparable officer *before* payment of dividends
  - Plan must be approved by the board of directors, management committee, executive committee or similar body (this can happen after payment of the dividend)
  - Plan must provide for reinvestment of dividends in the U.S. other than as payment for executive compensation

IRC § 965 – State Tax Implications

- **Conformity**
  - Post *Kraft*, many states enacted "fixes" to cure discrimination
  - Some "fixes" will not result in a state-level 85% DRD (e.g., Alabama) and thus discrimination may rise to the surface once again
  - Taxability in water's-edge combined reporting states will potentially result in disputes as well
- **Investment plans will trigger other state and local tax implications**
  - Incentives and credits
  - Sales tax exemptions
  - Property tax exemptions

State Non-Conformity and Additional Issues in Regard to § 199

- **Non-conformity to federal DRD**
  - California – dividend may be eliminated only if paid out of earnings and profits of a year in which the recipient was a member of the same unitary group as the payor
  - Other states with less than 100% DRD – *Kraft* may apply
- **Alternative state taxes that might apply to distribution**
  - Pennsylvania capital stock/franchise tax – uses book not taxable income – dividend income is included
  - New Jersey alternative minimum assessment
  - Kentucky alternative minimum calculation

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Thank You