U.S. Senate
Republican Policy
Committee

Legislative Notice

Jon Kyl, Chairman

No. 56 March 1, 2004

S. 1637 – Jumpstart Our Business Strength (JOBS) Act

Calendar No. 381

Reported by the Finance Committee on November 7, 2003, by a vote of 19-2, together with additional and minority views; S. Rept. 108-192.

Noteworthy

- In January of 2002, the World Trade Organization (WTO) Appellate Body found that the United States' extraterritorial income (ETI) tax regime, which was intended to provide tax benefits to U.S. companies that export domestically manufactured goods and limited services related to those goods, constituted a prohibited export subsidy under the relevant trade agreements.

- The WTO authorized the European Union to impose approximately $4 billion in tariffs on U.S. exports if the ETI tax regime is not repealed. As of today, March 1, 2004, the European Union began to exercise its authority to phase in retaliatory sanctions.

- On October 28, 2003, the House Ways & Means Committee marked up legislation similar to S. 1637, titled the American Jobs Creation Act of 2003 (H.R. 2896, H. Report 108-393). The House has not yet taken up this bill.

Background

Like many other countries, the United States has long provided benefits under its tax law to companies that export goods or services. In the United States, for most of the last two decades, these benefits were provided 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 In response to this WTO finding, the United States repealed the FSC rules and enacted a new tax regime, under the FSC Repeal and Extraterritorial Income Exclusion Act of 2000.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 the ETI tax regime also constituted a prohibited export subsidy under the relevant trade agreements.

Following hearings on the effects of the WTO ruling and options for replacing the FSC/ETI tax regimes, the Finance Committee marked up S. 1637, the Jumpstart Our Business Strength (JOBS) Act, on October 1, 2003, and ordered the bill favorably reported by a vote of 19 to 2. The House Ways & Means Committee marked up H.R. 2896, the American Jobs Creation Act of 2003 (H. Report 108-393), on October 28, 2003, by a vote of 24 to 15. The House has not taken up this legislation.

Bill Provisions

Below is a summary of the major provisions included in the JOBS Act. A full description of the bill's provisions and revenue estimates can be found in the Finance Committee's report, Senate Report 108-192.

<u>Repeal of the Exclusion for Extraterritorial Income</u>

- **Present Law.** Under the 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.

- **S. 1637.** In order to bring U.S. tax laws into compliance with the country's WTO obligations, the bill repeals the exclusion for extraterritorial income. However, the bill also provides that the extraterritorial-income exclusion remains in effect for transactions under binding contracts in effect on September 17, 2003.

The bill provides a transitional rule for certain corporations, under which they may claim a deduction for taxable years ending after the date of enactment and beginning before January 1, 2007. In general, the amount of the deduction is equal to a specified percentage of the amount that was excludable from the corporation's 2002 gross income under the extraterritorial-income exclusion in effect in 2002. The specified percentages are as follows:

Calendar Year	2004	2005	2006	2007 and later
Specified Percentage	80%	80%	60%	0%

The provision is effective for transactions occurring after the date of enactment.

Tax Deduction for American Manufacturers

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

- **S. 1637.** The bill replaces 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. The bill requires the Treasury Secretary to promulgate regulations governing the allocation of deductions, expenses, and losses to such 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 subject to the maximum 35 percent corporate tax rate.

Taxable Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Manufacturing Deduction Percentage	1%	2%	3%	6%	6%	9%	9%	9%	9%	9%
Manufacturing Tax Rate Cut	0.35%	0.7%	1%	2%	2%	3%	3%	3%	3%	3%
Resulting Tax Rate[1]	34.65%	34.3%	34%	33%	33%	32%	32%	32%	32%	32%

Under the bill, the new manufacturing-income deduction is limited by a factor that is based generally on the amount of the taxpayer's domestic manufacturing income compared to its worldwide manufacturing income. This limitation, which is often referred to as the "haircut" because it limits the

[1] Figures assume income subject to the maximum 35% corporate tax rate.

deduction benefits for manufacturers that have overseas operations, is reduced under the bill by 25 percent in 2010, by 50 percent in 2011, by 75 percent in 2012, and eliminated entirely in taxable years beginning after 2012.

The bill 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 to taxable years ending after the date of enactment.

International Tax Reform and Simplification Provisions

The bill includes a host of provisions designed 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 these multinational corporations, leaving them with additional capital for reinvestment and job creation. Key provisions in this section include:

- Expansion of the foreign-tax credit carryforward period from 5 years to 20 years and reduction of the carryback period from two years to one year.

- Repeal of the current 90-percent limitation on the use of foreign tax credits when calculating the alternative minimum tax.

- Modification of the interest-allocation rules to permit the allocation of interest expenses of the domestic members of a multinational group on a worldwide basis, thereby increasing the group's potential foreign tax credit.

- Temporary reduction in the applicable tax rate to 5.25 percent for certain dividends received from controlled foreign corporations.

A complete discussion of these provisions is included in the Committee's report (see pages 14-57).

Domestic Manufacturing and Business Provisions

The bill includes a number of business tax provisions, many of which complement the Committee's goal of providing tax benefits for American manufacturers. The legislation also contains provisions specifically relating to film production and timber. Key provisions in this section include:

- Expansion of the total capital expenditure limitation under the qualified small-issue bond program from $10 million to $20 million.

- Expensing of investments in broadband equipment, rather than capitalizing and depreciating such equipment.

- Modification of the small business expensing limitation under section 179 so that the deduction is reduced by only 50 percent (instead of the current 100 percent) of each dollar invested above the current $400,000 phase-out threshold.

- Expansion of the net operating loss (NOL) carryback rules from two years to three years for NOLs arising in 2003, and full deductibility of NOLs arising in such years for purposes of calculating the business' alternative minimum tax.

A complete discussion of these provisions is included in the Committee's report (pages 58-83).

<u>Tax Shelter, Corporate Governance, and Other Revenue Provisions</u>

The bill includes a package of provisions intended to curtail tax shelters, improve corporate governance, and discourage expatriation. Key provisions in this section include:

- Codification of the economic substance doctrine.

- Increased penalties with respect to listed and reportable transactions.

- Requirement that the Chief Executive Office sign a corporation's tax return.

- Denial of tax deductions for certain fines, penalties, settlements, and punitive damages imposed on taxpayers.

- Modifications to address corporate inversion transactions.

- Expansion of the current limitation on expensing of certain passenger vehicles, such as sport utility vehicles (SUVs).

- Limitation on the tax benefits arising from "sale-in/lease-out" transactions with tax-exempt entities.

- Extension of IRS and Customs user fees.

A complete discussion of these provisions is included in the Committee's report (pages 83-225).

Cost

The Joint Committee on Taxation (JCT) estimates that the JOBS Act will raise revenues by $9.102 billion over five years (fiscal years 2004 through 2008) and $473 million over 10 years (fiscal years 2004 through 2013). Based on the provisions described above, the bill's revenue effects are allocated as follows:

Provisions of the Bill	Revenue Increase/(Loss) over 5 Years (in millions)	Revenue Increase/(Loss) over 10 Years (in millions)
Repeal of the ETI tax regime	$24,403	$55,688
New manufacturing deduction and ETI transition rule	(22,951)	(69,953)
Subtotal	1,452	(14,265)
International tax reform and simplification provisions	(8,947)	(36,857)
Domestic manufacturing and business provisions	(7,274)	(5,338)
Subtotal	(16,221)	(42,195)
Tax shelter, corporate governance and other revenue provisions	23,871	56,933
Net Total	9,102	473

The complete revenue estimate appears in the Committee report (pages 226-230).

Administration Position

At press time, the Administration had not released a Statement of Administration Policy, although Treasury Secretary Snow testified before the Senate Budget Committee on February 13, 2004, that "the priority now [is] on just getting us into compliance in a way that doesn't prejudice U.S. businesses and doesn't create distortions in the [tax] code."

In the President's Fiscal Year 2005 Budget, the Administration included a proposal for replacing the FSC/ETI tax regime. In general, this proposal focuses on changes to the tax law that increase the competitiveness of American manufacturers and other job-creating sectors of the economy, including a corporate income tax rate reduction. The Administration's proposal also includes permanent extension of the research and experimentation (R&E) tax credit, increased expensing for small businesses, extension of the waiver on the use of NOLs under the alternative minimum tax (AMT), and AMT reform in general.

A complete discussion of the Administration's proposals can be found in the Treasury Department's *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals* (pages 187-189) – http://www.treasury.gov/offices/tax-policy/library/bluebk04.pdf .

Possible Amendments

- Substitute Amendment: Senators Kyl and Nickles intend to offer a substitute amendment that primarily would replace the bill's manufacturing deduction with a straight rate reduction for all corporate taxpayers. The amendment would also make modifications to the AMT in order to reduce its detrimental effects on corporate taxpayers, especially in the manufacturing sector.

- Elimination of the "Haircut": Senators Smith and Breaux intend to offer an amendment that would eliminate the limitation on the bill's manufacturing deduction for manufacturers that have overseas operations.

- Limitation on Special Dividends Tax Rate: Senator Breaux intends to offer an amendment that would direct that taxpayers benefitting from the reduced tax rate on certain dividends received from controlled corporations must use such tax savings for reinvestment and job creation.

- Permanent Haircut: Senator Stabenow may offer an amendment to make the "haircut" permanent, based on the argument that there should be a disincentive for American manufacturers to conduct their manufacturing activities abroad.