

Tax Update — October 22, 2004

The American Jobs Creation Act of 2004

On Friday, October 22, President Bush signed the American Jobs Creation Act; sweeping tax legislation intended, among other things to: effectively reduce tax rates for US manufacturers from 35% to 32%, significantly revise the taxation of US companies with foreign operations, provide additional relief to S corporations and their shareholders, and further curb abuses of tax shelters entered into both by corporation and individuals. This outline, prepared by the Firm's Tax Practice Group, sets forth a short discussion of those aspects of the Act that are most likely to have an impact on our clients. Significant changes were made to the taxation of deferred compensation. Those previously were covered by a memorandum circulated by the Firm's Employee Benefits Group. Interestingly, Congress made no changes to the Gift and Estate Tax Provisions. If you would like to discuss any aspect of the Act as it applies to the clients for whom you are responsible, please feel free to contact a member of the Tax Practice Group (listed at the end of this outline). **Except as otherwise expressly noted below, the Act is effective for taxable years beginning after October 22, 2004.**

Corporate Changes

Definition of Controlled Group of Brother-Sister Corporations Modified.

The Act amends the Internal Revenue Code (the "Code") by changing the definition of a controlled group of brother-sister corporations for purposes of the restrictions regarding corporate tax brackets, the accumulated earnings credit and the minimum tax exemption for a controlled group of corporations. For purposes of these provisions, a brother-sister controlled group is defined simply as two or more corporations owned by five or fewer persons who are individuals, estates or trusts who possess more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the value of shares of all classes of stock of each corporation, taking into account the stock ownership of each person only to the extent the stock ownership is identical for each person. For other purposes, the prior definition of a brother-sister controlled group continues to apply. Under the definition in effect prior to the Act, a controlled group of brother-sister corporations was defined as two or more corporations owned by five or fewer persons who were individuals, trust or estates who possessed: (1) at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of the stock of each corporation and (2) more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of all shares of all classes of stock of each corporation, taking into account the stock ownership of each person only to the extent it was owned identically in each corporation. In other words, the 80% test has been dropped from the definition of a controlled group of brother-sister corporations for purposes of the restrictions regarding the corporate tax brackets, the accumulated earnings credit and the minimum tax exemption.

New Reporting Requirements for Taxable Acquisitions.

The Act imposes an information reporting requirement on an acquiring corporation if any shareholder of a target corporation recognizes gain or loss in whole or in part by reason of an acquiring corporation's acquisition of the stock or assets of the target corporation. As a result, the acquiring corporation (or the stock transfer agent of the target corporation) must file a return setting forth: (1) a description of the acquisition; (2) the name and address of each shareholder of the acquired corporation who is required to recognize gain as a result of the acquisition; (3) the amount of money and the fair market value of other property transferred to each shareholder as part of the acquisition; and (4) any other information the IRS may prescribe. In addition, by January 31 of the year following the calendar year during which the taxable transaction occurred, the acquiring corporation is required to furnish each shareholder whose name appears in the return the same information as set forth in the return. The pre-Act penalties for failure to comply with information reporting requirements are extended by the Act to failures to comply with the filing requirements of this provision. The new reporting requirement applies to acquisitions after October 22, 2004.

Definition of Nonqualified Stock Clarified.

For purposes of making a tax free transfer to a controlled corporation in exchange for stock, nonqualified preferred stock is treated as taxable proceeds. For those purposes, nonqualified preferred stock was defined as stock which is limited and

preferred as to dividends, but does not participate in corporate growth “to any significant extent.” The Act clarifies the definition of nonqualified stock so that stock is not to be treated as participating in corporate growth “to any significant extent” unless there is a real and meaningful likelihood that the shareholder will actually participate in the earnings and growth of the corporation. This modification is applicable to transactions occurring after May 14, 2003.

Modification of Treatment of Transfers to creditors in Divisive Reorganizations.

The Act limits the amount of money and property that may be distributed by a corporation in a tax-free divisive reorganization without recognizing gain. If certain conditions are met, a corporation can effect a tax-free separation of one of its businesses in a tax-free manner by contributing the business to a controlled subsidiary in exchange for stock and other property and then distributing the stock of the controlled subsidiary and property to its shareholders and creditors. The distributing corporation does not recognize gain if it receives money or other property and then distributes that money or other property to its shareholders or creditors. Under prior law, the amount of property that could be distributed to creditors without the recognition of gain to the distributing corporation was unlimited. The Act limits the amount of money and fair market value of other property that can be received by the distributing corporation and then distributed to its creditors without gain recognition to the amount of the tax basis of the assets transferred to the controlled corporation in the divisive reorganization. This provision is effective to transactions occurring on or after October 22, 2004.

Disallowance of Built in Loss Assets to a Corporation.

Generally, no gain or loss is recognized upon the transfer of property by one or more persons to a corporation in exchange for stock of the corporation if, immediately after the transfer, the transferors control (i.e., own more than 80%) the corporation. The Act limits the built in loss of property transferred to such a corporation in a transaction treated as a non-taxable transfer in exchange for stock of the controlled corporation. If the aggregate adjusted basis of property transferred to a controlled corporation in exchange for stock in a tax-free exchange exceeds the aggregate fair market value of the property, then the aggregate adjusted tax basis of the property transferred to the controlled corporation is limited to the fair market value of the property. This provision, which is designed to curb certain abusive tax shelters, is effective to transactions occurring after December 31, 2003.

Reincorporation In Foreign Jurisdiction.

To avoid U.S. tax on foreign source income and sales of foreign corporation stock, U.S. corporations have engaged in transactions commonly referred to as “inversions,” whereby either (a) the U.S. parent corporation becomes a subsidiary of a foreign corporation, with the shareholders receiving stock in the new foreign parent corporation (a “stock inversion”) or (b) the U.S. parent corporation transfers its assets to a foreign corporation in exchange for stock of the foreign corporation which is distributed to its shareholders (“an asset inversion”). Pursuant to a stock inversion, the shareholders of the U.S. corporation recognize gain on the exchange of their shares for shares of the foreign corporation, while under an asset inversion the U.S. corporation recognizes gain on the transfer of its assets to the foreign corporation. Notwithstanding this front-end tax load, as widely publicized in the media, several well-known US corporations have engaged in such transactions hoping to achieve significant income tax reductions in the future.

The Act imposes new tax rules on inversion transactions. Where there is an inversion transaction and the shareholders of the U.S. corporation receive 50% or more of the stock of the foreign corporation, any applicable tax imposed in establishing the inverted structure is not offset by the tax attributes (e.g., net operating losses or foreign tax credits) of the former U.S. parent corporation. Any applicable corporate level income or gain required to be recognized by an expatriated entity under certain provisions of the Code dealing with the transfer of controlled corporation stock, or the transfer or license of other assets, by a U.S. corporation as part of the inversion transaction, as well as other provisions of the Code, will be recognized, without the benefit of any tax attributes of the U.S. corporation. These new rules apply for a ten year period following the completion of the inversion transaction, so that any gain or income as a result of a transfer or license by the U.S. corporation to the new foreign parent corporation or a related party is recognized without the benefit of any tax attributes of the U.S. corporation. If in an inversion transaction the shareholders of the U.S. corporation end up owning 80% or more in vote or value of the new foreign parent corporation and the new foreign parent corporation and its related entities do not have substantial business activities in the country of incorporation, the new foreign parent corporation is deemed to be a domestic corporation for all purposes of the

Code. Consequently all of the intended tax benefits of this type of inversion is denied. The provision is effective for transactions occurring on or after March 4, 2003.

Other Corporate Tax Changes.

The Act also modifies or repeals certain rules relating to the following:

- The Code Section 355 “active business test” applied to chains of affiliated corporations.
- Temporary suspension of personal holding company tax.
- Temporary accumulated earnings tax safe harbors.

The prohibition on non-recognition of gain through complete liquidation of holding company.

S Corporation Reform and Simplification.

Except as expressly otherwise noted, each of the changes set forth below are effective for taxable years beginning after December 31, 2004.

Determining the Number of S Corporation Shareholders.

For purposes of determining the number of shareholders that an S corporation is deemed to have, all members of a family are treated as one shareholder. The “family” is determined by identifying the common ancestor and all of his or her lineal descendants (including adopted children) along with the spouses and former spouses of any such person. When the S election is made, the common ancestor cannot be more than six (6) generations removed from the youngest generation of shareholders.

Further, the total number of allowable S corporation shareholders has been increased from 75 to 100.

These changes make it much easier for family owned business to remain qualified small business corporations and to retain their S elections even if the family becomes quite large.

Changes Involving Electing Small Business Trusts (“ESBTs”).

An ESBT generally is a multi-beneficiary “spray” trust. For purposes of determining the total number of S corporation shareholders, each person who could be entitled to receive a distribution of trust income or principal due to the exercise of the trustee’s discretion or otherwise during a particular period (each, a “potential current beneficiary”) is treated as a separate shareholder during such period.

Under the Treasury Regulations, lifetime powers of appointment currently are deemed to be fully exercised in determining the number of S corporation shareholders. As a result, if a beneficiary had the power to appoint, for example, trust income or principal to one or more charitable beneficiaries, the trust could not hold S corporation shares since there are a vast number of potential beneficiaries and the IRS would treat the corporation as having an impermissible number of shareholder. Under the Act, such powers are disregarded until and unless they are exercised.

To protect against inadvertent terminations of an S election, the “grace period” during which an ESBT can dispose of S corporation stock after an ineligible shareholder (e.g., a nonresident alien, corporation, partnership or limited liability company) becomes a potential current beneficiary is increased from 60 days to one year.

Loss Limitations of S Corporation Shareholders.

S corporation shareholders are able to deduct their allocable shares of corporation deductions and losses only to the extent of their basis in their S corporation shares and any loans they make to the S corporation. Losses in excess of such amounts are

“suspended.” If a shareholder with suspended losses was required to transfer some or all of his or her shares to a spouse or to a former spouse in connection with a divorce, under the Act a proportionate amount of such losses can be transferred to the spouse or former spouse for use in a later year when basis is increased. Without this change, the suspended losses attributable to such transferred shares would be unavailable to either spouse or former spouse.

Income attributable to S corporation shares held by a qualified subchapter S trust (“QSST”) is taxed to the electing beneficiary thereof. Under current law, the QSST, rather than the beneficiary, is treated as the owner of the shares for purposes of determining the income tax consequences of a disposition of the S corporation shares. The Act would allow the QSST beneficiary to deduct any suspended losses under the at-risk rules or the passive loss rules when the QSST disposes of the S corporation shares. Under prior law, such losses remained suspended at the beneficiary level even if the QSST recognized a significant gain upon the sale of the shares.

S Elections Made by Financial Institutions.

An S corporation that had “regular” or “C corporation” earnings and profits (i.e., an S corporation that formerly operated as a C corporation) may be subject to tax on its excess passive investment income (if its passive investment income exceeded 25% of its total gross receipts for a taxable year). Further, if this occurred during three consecutive years, the S election of the corporation terminated. Passive investment income includes, among other things, dividends and interest. The Act provides that dividends and interest on assets required to be held by a bank, bank holding company or financial holding company are not passive investment income for these purposes.

An IRA or Roth IRA that holds S corporation bank stock on the date of enactment of the Act qualifies as an S corporation shareholder. S corporation income and gain attributable to the ownership or sale of those shares, however, will be taxable as unrelated business taxable income (“UBTI”). The Act also provides that the sale of bank stock by an IRA to its beneficiary is exempt from the prohibited transaction rules so long as the shares are owned by the IRA on the date of enactment.

Restricted bank director stock of an S corporation is not treated as being outstanding in determining whether the bank has as impermissible second class of stock, more than 100 shareholders, owns 100% of the shares of a subsidiary or for purposes of allocating income or loss among the corporation’s shareholders. “Restricted bank director stock” is the stock of a bank, banks holding company or financial holding company that, by agreement, is required to be sold back to the corporation when the holder ceases to be a director at same price that the director originally paid for the shares.

Qualified Subchapter S Subsidiaries (“QSSSs”).

The Act expressly allows the IRS to waive inadvertent invalid QSSS elections made in respect of a subsidiary so as to treat the subsidiary, in effect, as a disregarded branch or division of the S corporation for income tax purposes. It also give the Treasury authority to provide guidance regarding the reporting of informational income tax returns for QSSSs.

Other Changes.

The Act also provides retroactive relief to S corporations which have employee stock option plans (“ESOPs”) as shareholders by allowing distributions on allocated shares to be used to repay the outstanding ESOP loan. Under prior law, doing so would have been a clear violation of the prohibited transaction rules. In consideration for this additional flexibility, the ESOP must allocate to the participant’s account additional shares having a value equal to the cash distribution used to repay the ESOP loan. These changes apply to distributions made after December 31, 1997.

Provisions Related to Tax Shelters

The Act attempts to curtail the use of abusive tax shelters by imposing more stringent information disclosure requirements with respect to reportable transactions, accompanied by severe penalties for failure to comply with such requirements. In addition, the Act also targets specific transactions that have been used in past for tax avoidance purposes and grants more enforcement authority to the IRS.

Penalties in Connection With Reportable Transactions

Penalties for Non-Disclosure of Reportable Transaction

The IRS maintains and publishes a list of transactions (“listed transactions”) that it has identified as abusive, tax-avoidance transactions. In addition, the IRS has identified several other types of “reportable transactions” including transactions offered under conditions of confidentiality, transactions offering contractual protection for unfavorable tax consequences, transactions that generate loss deductions in excess of certain levels, transactions by large corporations in which the tax treatment differs from the book treatment by more than \$10 million or transactions that involve a brief asset holding period. Both listed transactions and reportable transactions have to be disclosed to the IRS under the current law, however, there are no real penalties for the failure to do so.

The Act imposes \$10,000 penalty on a taxpayer who is a natural person if the taxpayer fails to disclose a reportable transaction on his or her tax return. This penalty is increased to \$50,000.00 for all other types of taxpayers. If the taxpayer fails to disclose a listed transaction, the penalty amounts increase to \$100,000 and \$200,000 accordingly. While the penalty for failure to disclose a reportable transaction can be abated, the penalty for failure to disclose a listed transaction is non-negotiable. The new penalties apply for all tax returns due after October 22, 2004.

In addition, public companies must disclose to the SEC certain penalties relating to non-disclosure, gross valuation penalty and understatement penalties in connection with listed transactions.

Accuracy Related Penalties for Reportable Transactions

The Act imposes a 30% understatement penalty on any tax understatement attributable to an inadequately disclosed listed transaction or a reportable transaction with significant tax-avoidance purpose. The penalty is 20% for understatements attributable to such a transaction if it has been disclosed to the IRS.

Loss of Confidentiality Privileges Relating to Taxpayer Communications

Under the Act, communications with respect to tax shelters are not entitled to the protection of confidentiality otherwise applicable to taxpayer-advisor communications provided by the Code.

Loss of Interest Deduction

The Act disallows a deduction for interest on underpayments attributable to undisclosed listed transactions or reportable transactions with significant tax avoidance purpose.

Extension of Statute of Limitations

The statute of limitations with respect to undisclosed Listed Transaction will not expire until after the one year anniversary of the earlier of (a) disclosure of such transaction to the IRS or (b) the date a material advisor provides the Secretary with the list of participants to such transaction in compliance with such material advisor’s list-keeping obligations. A “material advisor” means, generally, a person who provides or provided advice regarding the formation and operation of a reportable transaction and who received income over certain levels. The new statute of limitations will apply for taxable years with respect to which the statute of limitations for assessing a deficiency did not expire before October 22, 2004.

New Penalties and Record-Keeping Requirements for Material Advisors and Promoters.

The Act imposes more stringent list-keeping requirements and requirements to disclose reportable transactions by a material advisor to participants in such transactions, as well as new, more severe penalties for failure to comply with such requirements. A material advisor who fails to furnish an information return with respect to a reportable transaction is subject to a penalty of \$50,000. With respect to a listed transaction, the penalty is increased to the greater of \$200,000 or 50% of the gross income of the material advisor with respect to such transaction (75% if the failure to report is deemed to be willful). Failure to furnish investor lists as required will subject a material advisor to a \$10,000 per day penalty. In addition, the Act imposes a penalty on the promoters of tax shelters in an amount equal to 50% of the gross income derived or to be derived from the activity for which the penalty is imposed.

Injunctions.

In addition to civil actions to enjoin any person from promoting abusive tax shelters or aiding and abetting the understatement of tax liability as permitted under the current law, the Act also allows to seek injunctions with respect to requirements relating to the reporting of reportable transactions, material advisor list-keeping obligations and violations of any of the rules regulating the practice of representatives of persons before the Department of Treasury. This provision was effective on October 23, 2004.

Other Provisions

Change in Substantial Understatement Definition for Corporate Taxpayers

Under the current law, a corporate taxpayer has a “substantial understatement of tax” (subject to 20% penalty) if the correct income tax liability exceeds the amount reported as a tax liability by the taxpayer by the greater of 10% of the correct tax or \$5000 (\$10,000 for most corporations). The Act increases the threshold amount in the definition of substantial understatement for a corporate taxpayer in connection with non-reportable transaction to the lesser of (a) the greater of \$10,000 or 10% of the tax required to be shown or (b) \$10,000,000.

Penalty for Failure to Disclose Foreign Accounts

The Act adds a civil penalty of \$10,000 for a non-willful failure to disclose accounts with a foreign financial entity and increases the penalty for willful non-disclosure to the greater of \$100,000 or 50% of the amount of the transaction or the account. This provision is effective for any failure to report occurring on or after October 22, 2004.

Deposits Made to Suspend Running of Interest on Underpayments

The Act provides that if a taxpayer after October 22, 2004, makes a deposit with the IRS on the account of a disputed item and such deposit is returned to a taxpayer, the returned amount attributable to a disputed item will earn interest at the applicable Federal Rate. All items included in a 30-day letter are deemed disputable for this purpose.

Changes Affecting Partnerships

In connection with the anti-tax shelter measures described above, the Act contains several technical changes applicable to partnerships that are designed to prohibit certain perceived abuses applicable to the taxation of partners. Among those changes are the following.

Disallowance of Certain Partnership Loss Transfers

The Act provides that any built-in loss in contributed property may only be taken into account by the contributing partner. Except as provided in regulations, for purposes of allocating items to partners other than the contributing partner, the basis in such property will be the fair market value of the property at the time of contribution. Therefore, if the contributing partner's interest in the partnership is transferred or liquidated, the partnership's adjusted basis of the contributed property will be its fair market value and any benefit that the built-in loss otherwise would have provided to the remaining partners will be eliminated.

With certain limited exceptions applicable to securitization partnerships, the transfer of a partnership interest in respect of which there is a substantial built-in loss (i.e., if the partnership's adjusted basis in the property exceeds the fair market value of the partnership property by more than \$250,000) requires a mandatory “step down” in the partnership's basis in the property to which the built-in loss relates. The mandatory step down does not apply, however, to certain electing investment partnerships. The Act also requires a similar basis reduction in the case of certain partnership distributions that result in a downward adjustment of more than \$250,000.

These provisions will be effective for contributions, distributions and transfers occurring after October 22, 2004.

Recognition of Cancellation of Indebtedness Income

Under prior law it was unclear whether a partnership recognized cancellation of indebtedness income when the partnership transferred to a creditor a capital or profits interest in the partnership. The conversion of debt to equity is a common transaction for which there is an express exemption applicable to corporations. The Act specifically provides that a partnership that transfers a partnership interest to a creditor in satisfaction of indebtedness will be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the partnership interest. Thus, cancellation of indebtedness income will be recognized to the extent that the principal amount the debt exceeds the fair market value of the partnership interests so transferred. This new rule applies irrespective of whether the converted debt was recourse or non-recourse in nature. Any cancellation of indebtedness income arising from such a transfer must be allocated solely among the partners holding interests in the partnership immediately prior to the satisfaction of the debt. This provision applies to cancellations of indebtedness occurring on or after October 22, 2004.

Tax-Exempt Leasing Provisions

The Act dramatically changed the tax rules relating to the leasing of property to governmental and other tax-exempt entities. Although leases of property to tax-exempt entities were previously subject to very modest anti-abuse rules, Congress felt that governmental entities in particular were entering into leasing arrangements with corporations that allowed an entity to retain substantially all of the economic incidents of ownership through lease arrangements where all of the entity's financial obligations were completely defeased through an upfront payment by the lessor to the governmental or tax-exempt lessee. Under the Act, the typical lease arrangement between a U.S. corporate lessor and a governmental or tax-exempt lessee is stripped of its favorable tax benefits.

Depreciation.

Tax-exempt use property must be depreciated on a straight line basis over a depreciation recovery period equal to the longer of the property's class life or 125 percent of the lease term. This requirement has been expanded to include intangibles. Moreover, in determining the lease term for purposes of the 125 percent calculation, all service contracts between the lessor and lessee that relate directly or indirectly to the lease are included.

Qualified Technological Equipment.

For purposes of determining whether a lease of qualified technological equipment to a tax-exempt entity satisfies the present 5-year short-term lease exception for leases of qualified technological equipment, the Act provides that the term of the lease does not include an option or options of the lessee to renew or extend the lease, provided the rents under the renewal or extension are based upon fair market value determined at the time of the renewal or extension. The aggregate period of such renewals or extensions not included in the lease term under this provision may not exceed 24 months. In addition, this provision does not apply to any period following the failure of a tax-exempt lessee to exercise a purchase option if the result of such failure is that the lease renews automatically at fair market value rents.

Limitations of Deductions and Losses.

The Act provides that if a taxpayer leases property to a tax-exempt entity, the taxpayer may not claim deductions for a taxable year from the lease transaction in excess of the taxpayer's gross income from the lease for that taxable year.

This provision applies to deductions or losses related to a lease to a tax-exempt entity and the leased property. Deductions related to a lease of tax-exempt use property include any depreciation or amortization expense, maintenance expense, taxes or the cost of acquiring an interest in, or lease of, property. In addition, this provision applies to interest that is properly allocable to tax-exempt use property, including interest on any borrowing by a related person, the proceeds of which were used to acquire an interest in the property, whether or not the borrowing is secured by the leased property or any other property. Any disallowed deductions are carried forward and treated as deductions related to the lease in the following taxable year subject to the same limitations. Under rules similar to those applicable to passive activity losses (including the treatment of dispositions of property in which less than all of the gain or loss from the disposition is recognized), a taxpayer generally is permitted to deduct previously disallowed deductions and losses when the taxpayer completely disposes of its interest in the property.

A lease of property to a tax-exempt lessee is not subject to these severe deduction limitations if the lease satisfies all of the following requirements:

(a) In general, the tax-exempt lessee may not monetize its lease obligations (including any purchase option) in an amount that exceeds 20 percent of the taxpayer's adjusted basis in the leased property at the time the lease is entered into. A lease does not satisfy this requirement if the tax-exempt lessee monetizes such excess amount pursuant to an arrangement, set-aside, or expected set-aside, that is to or for the benefit of the taxpayer or any lender, or is to or for the benefit of the tax-exempt lessee, in order to satisfy the lessee's obligations or purchase options under the lease. This determination shall be made continuously during the lease term and shall include the amount of any interest or other income or gain earned on any amount set aside or subject to an arrangement described in this provision. Arrangements to monetize lease obligations include defeasance arrangements, loans by the tax-exempt entity (or an affiliate) to the taxpayer (or an affiliate) or any lender, deposit agreements, letters of credit collateralized with cash or cash equivalents, payment undertaking agreements, prepaid rent, sinking fund arrangements, guaranteed investment contracts, financial guaranty insurance, or any similar arrangements.

(b) The taxpayer/lessor must make and maintain a substantial equity investment in the leased property. For this purpose, a taxpayer/lessor generally does not make or maintain a substantial equity investment unless (1) at the time the lease is entered into, the taxpayer/lessor initially makes an unconditional at-risk equity investment in the property of at least 20 percent of the taxpayer's adjusted basis in the leased property at that time, (2) the taxpayer maintains such equity investment throughout the lease term, and (3) at all times during the lease term, the fair market value of the property at the end of the lease term is reasonably expected to be equal to at least 20 percent of such basis. For this purpose, the fair market value of the property at the end of the lease term is reduced to the extent that a person other than the taxpayer bears a risk of loss in the value of the property. This requirement does not apply to leases with lease terms of 5 years or less.

(c) The tax-exempt lessee generally may not assume or retain more than a minimal risk of loss in the lease transfer, other than the obligation to pay rent and insurance premiums, to maintain the property, or other similar conventional obligations of a net lease. For this purpose, a tax-exempt lessee assumes or retains more than a minimal risk of loss if, as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt lessee, the taxpayer is protected from either (1) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than the leased property's reasonably expected fair market value at the time the lease is terminated, or (2) an aggregate loss that is greater than 50 percent of the loss that would occur if the fair market value of the leased property were zero at lease termination. This requirement does not apply to leases with lease terms of 5 years or less.

(d) A tax-exempt lessee may not have an option to purchase the leased property for any stated purchase price other than the fair market value of the property (as determined at the time of exercise of the option). This requirement does not apply to (1) property with a class life (as defined in section 168(i)(1)) of seven years or less, or (2) any fixed-wing aircraft or vessels (i.e. ships).

These loss disallowance provisions continue to apply throughout the lease term to property that initially was tax-exempt use property, even if the property ceased to be tax-exempt use property during the lease term. In addition, this provision is applied before the application of the passive activity loss rules under Code Section 469.

Effective Date.

The leasing provisions in the Act are generally effective for leases entered into after March 12, 2004. However, these provisions do not apply to property located in the United States that is subject to a lease with respect to which a formal application (1) was

submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004, (2) is approved by the Federal Transit Administration before January 1, 2006, and (3) includes a description and the fair market value of such property.

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There are two additional points to consider when evaluating the tax-exempt leasing provisions of the Act. First, the legislative history makes it clear that the special provisions relating to disallowed losses and the exceptions to the disallowed loss rules only apply to tax-exempt leases. None of these new rules should be viewed as applicable to traditional leasing transactions where the lessee is a United States taxpayer. Finally, since the United States tax benefits of long-term leases of United States property to tax-exempt or governmental lessees have virtually evaporated, expect that foreign corporations will become the primary counterparty in terms of sale/leaseback transactions involving United States tax-exempt or governmental entities.

For Further Information

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