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Job Creation and Worker Assistance Act of 2002

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On March 9, 2002, the President signed into law the "Job Creation and Worker Assistance Act of 2002" (The Act) (P.L. 107-147). The Act is a combination of business economic stimulus provisions, relief provisions for lower-Manhattan businesses affected by the 9/11 terrorist attacks, a 13-week extension of unemployment benefits, extensions for expired or soon to expire tax breaks, and technical corrections.

Business economic stimulus provisions in the Act include:

- An additional 30 percent first-year depreciation for most types of new, non-realty property acquired after September 10, 2001, and before September 11, 2004. In general, the property must be placed in service by the taxpayer before 2005 (before 2006 for certain property with longer production periods). The additional depreciation allowance applies for qualifying property placed in service after September 10, 2001.
- An increase in net operating loss (NOL) carry-back periods to five years for NOLs arising in tax years ending in 2001 or 2002.
- A temporary waiver of the limitation of use of NOLs against the alternative minimum tax (AMT). Under the Act, an alternative tax net operating loss deduction (ATNOL) arising in years ending in 2001 or 2002 or NOL carry forwards to the 2001 and 2002 tax years may offset 100 percent of a taxpayer's alternative minimum taxable income (AMTI).

Relief provisions for lower Manhattan businesses impacted by the 9/11 terrorist attacks include:

1. An additional 30 percent first-year depreciation is allowed for eligible nonresidential or residential realty (to the extent it rehabilitates realty damaged or replaces realty destroyed or condemned as a result of the September 11, 2001, terrorist attack) in the New York Liberty Zone (essentially, lower Manhattan).
2. Straight-line depreciation over five years is allowed (nine years under the alternative depreciation system) for qualified leasehold improvement property (generally, improvements to an interior portion of an existing nonresidential building other than certain structural improvements or expansions) that is in the Liberty Zone and placed in service after September 10, 2001, and before 2007.
3. A $35,000 increase in the regular maximum expensing allowance under Internal Revenue Code Section 179 is allowed for qualified Liberty Zone property, the original use of which commences with the taxpayer after September 10, 2001, and that is acquired by the taxpayer by purchase after that date and placed in service before 2007.
4. The replacement period for property involuntarily converted in the Liberty Zone as a result of the 9/11 terrorist attack is extended from two years to five years, but only if all of the replacement property is in New York City.
5. A new-targeted group of work opportunity credit (WOTC) eligible individuals is created for those who work for smaller businesses in the Liberty Zone, or elsewhere in New York City, if their business was forced to relocate because of the 9/11 terrorist attack.

Tax breaks extended for two years by the Act include:

1. The ability to use personal, nonrefundable credits to offset both regular and AMT liability
2. The work-opportunity tax credit and welfare to work credit
3. The credit for production of energy from alternative sources
4. Suspension of the 100 percent of taxable income limit on percentage depletion from marginal oil and gas wells

The Act includes numerous technical corrections relating to five previous tax laws. Several of these corrections (clarifications for the deemed sale-and-replacement election for five-year capital gains) affect 2001 returns filed in 2002. This current report explains the key changes made by this new law and when provisions are effective.

Business Provisions

Additional 30 percent first-year depreciation for most types of new depreciable property placed in service after September 10, 2001.

The cost of most types of depreciable property is recovered by way of the modified, accelerated, cost-recovery (MACRS) depreciation rules. In general, the recovery period and recovery method (straight-line or accelerated depreciation)

are determined by the property's asset class. Most property (other than buildings) depreciated under MACRS, requires depreciation deductions to be calculated, for purposes of determining AMTI, on the 150 percent declining balance method. Pre-Act law does not provide an additional first-year depreciation allowance for any type of property.

New law. Effective for "qualified property" acquired after September 10, 2001, and before September 11, 2004, the Act provides an additional depreciation deduction in the placed-in-service year equal to 30 percent of the adjusted basis of the "qualified property." "Qualified property" includes most types of new property other than buildings, but does include farm buildings.

The adjusted basis of "qualified property" is reduced an additional 30 percent depreciation deduction before computing the amount, otherwise this is allowable as a depreciation deduction for the tax year and any later tax year. There is no AMT depreciation adjustment for "qualified property" that provides for the additional 30 percent first-year depreciation allowance. There is no AMT adjustment for the entire recovery period of "qualified property."

Example 1: On September 20, 2001, ABCO, a calendar-year business, bought and placed into service $100,000 of five-year MACRS property. Applying the half-year depreciation convention, the first-year depreciation allowance under pre-Act law is $20,000 (20 percent). Under the Act, the business may claim a first-year depreciation allowance of $44,000 [($100,000 * 0.30 = $30,000) + ($100,000 - $30,000 * 0.20 = $14,000)].

The Joint Committee on Taxation's Technical Explanation of the Act makes it clear that if Internal Revenue Code Section 179 "expensing" is claimed on "qualified property," the amount expensed "comes off the top" before the additional 30 percent first-year depreciation allowance is computed. Then the taxpayer computes regular, first-year depreciation (and depreciation for future years) with reference to the adjusted basis remaining after expensing and after the additional 30 percent first-year allowance.

Example 2: The facts are the same as in the first illustration, except that ABX is eligible and elects to expense $24,000 of the cost of the assets placed in service on September 20, 2001. Under pre-Act law, the business could write off only $39,200 of the cost of the asset for 2001 [$24,000 expensing + ($100,000 - $24,000 * 0.20 = $15,200)]. Under the Act, the business may write off $57,440 [($24,000 expensing + ($100,000 - 24,000 * 0.30 = $22,800) + ($100,000 - $24,000 - $22,800 * 0.20 = $10,640)].

The additional 30 percent depreciation allowance is available for "qualified property" whether the half-year or mid-quarter depreciation convention applies in the placed-service year, and may be claimed even if the property is placed in service on the last day of the taxpayer's tax year.

The Joint Committee on Taxation's Technical Explanation of the Act also explains that the additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible or subject to the regular capitalization rules or the uniform capitalization rules. The additional 30 percent first-year depreciation allowance applies to "qualified property" unless the taxpayer "elects out." The election out may be made for any class of property for any tax year, and if made applies to all property in that class placed in service during that tax year.

Planning Note. Two situations in which a taxpayer might consider opting out for one or more classes are (1) where the taxpayer has about-to-expire NOLs, and (2) where the taxpayer anticipates being in a higher tax bracket in future years.

Caution. A taxpayer that "elects out" of additional first-year depreciation for a specific class of property is subject to the AMT depreciation adjustment for property in that class. That means AMT depreciation is computed using the 150 percent declining balance method (switching to straight-line in the year necessary to maximize the allowance), except that straight line is used for property for which straight line depreciation must be used for regular tax purposes. The recovery period is the same for AMT and regular tax purposes.

Qualifying for the Additional 30 percent First-year Depreciation Allowance

A taxpayer may claim the additional first-year allowance if each of the following conditions are met:

- The asset is "qualified property."
- The original use of the asset begins with the taxpayer after September 10, 2001.
- The asset is timely acquired and timely placed in service.

"Qualified Property" Eligible for Additional 30 percent First-year Depreciation

To be eligible for the additional 30 percent first-year depreciation allowance, an asset must fall within one of four asset classes covered below and meet the original use and timely acquisition requirements.

Class #1. The property must be subject to the MACRS depreciation rules and have a recovery period of 20 years or less.

Practitioner observation. This broad area covers most types of depreciable non-realty property, and includes all of the following assets:

- Three-year MACRS property, such as tractor units for use over-the-road; breeding hogs; special handling devices used in the manufacture of food and beverages; special tools used in the manufacture of rubber products, finished plastic products, and motor vehicles; race horses more than two years old when placed in service; and other horses more than 12 when placed in service.
- Five-year MACRS property, which includes information systems (computers); heavy general purpose trucks; trailers and trailer-mounted containers; breeding or dairy cattle; certain assets used in the drilling of oil and gas wells, construction, the manufacture of textile yarns, apparel, and other finished goods, and the cutting of timber; automobiles or light-general purpose

trucks; qualified technological equipment; and Internal Revenue Code Section 1245 property used in connection with research and experimentation.
- Seven-year MACRS property, which includes office furniture, fixtures, and equipment; machinery and equipment used in agriculture; certain assets (except helicopters) used in air transport; certain assets used in exploration for and production of petroleum and natural gas products, the manufacture of wood products and furniture, and theme and amusement parks, and recreation facilities (e.g., bowling alleys); property that does not have a class life and is not specifically assigned to any other MACRS class; and breeding and work horses two years or younger when placed in service, and any horse not in any other category.
- Ten-year MACRS property, which includes water-transport equipment not used in marine construction; assets used in petroleum refining, manufacture of grain and grain mill products, sugar and sugar products, and vegetable oils and vegetable oil products; a single purpose agricultural or horticultural structure; and any tree or vine bearing fruit or nuts.
- 15-year MACRS class property, which includes land improvements (e.g., sidewalks and roads) that are not explicitly included in another class and are not buildings or structural improvements; and assets such as a service station and a car wash.
- 20-year MACRS class property, which includes farm buildings (other than single purpose agricultural or horticultural structures) and gas utility distribution facilities.

Class #2. This class consists of computer software available for purchase by the general public. Additional first-year depreciation is not available for computer software purchased as a part of an "on-going" business that must be paid off.

Class #3. This class consists of "water utility property."

Class #4. This class consists of qualified leasehold improvement property (other than "qualified New York Liberty Zone leasehold improvement property"), which is an improvement to an interior portion of a building, which is nonresidential property, if each of the following conditions is met:
- The improvement is made under or pursuant to a lease, either by the lessee, sub-lessee, or lessor of the building portion.
- The portion of the building is to be occupied exclusively by the lessee (or any sub-lessee) of the portion.
- The improvement is placed in service more than three years after the date the building was first placed in service.

Planning Pointer. Taxpayers who want to take advantage of additional 30 percent first-year depreciation for improvements being made in relatively new buildings, i.e., buildings placed in service within the last three years, should avoid placing the improvements in service within that three-year period.

Qualified, leasehold-improvement property does not include any improvement for which the expense is attributable to the following:
- Enlargement of the building.
- Any elevator or escalator.
- Any structural component benefiting a common area.
- The internal structural framework of the building.

For the above definition of qualified, leasehold-improvement property, a commitment (i.e., a binding commitment) to enter into a lease is treated as a lease. The parties to the commitment are treated as lessor and lessee. For purposes of the above definition, a lease between related persons is not considered a lease. Related persons are members of an affiliated group and persons having a relationship described in Internal Revenue Code Section267(b) using an 80 percent or more test (instead of a more than 50 percent test).

Property Not Eligible for Additional Depreciation Allowance

The following types of property are ineligible for the additional, 30 percent first-year depreciation allowance:
- Property that must be depreciated under the alternative depreciation system (e.g., tangible personal property used predominantly outside the U.S.).
- Listed property (such as a passenger auto) that is not used more than 50 percent for business.
- New York Liberty Zone qualified leasehold improvement property. (Internal Revenue Code Section168(k)(2)(C), as amended by Act Sec. 101(a)).

Original-use Requirement for Additional 30 percent First-year Depreciation

"Qualified property" eligible for an additional 30 percent first-year depreciation, the original use of the property must begin with the taxpayer after September 10, 2001. In other words, the property must be new property. The Joint Committee on Taxation's Technical Explanation of the Act explains that "original use" means the first use of the property, whether or not that use corresponds to the use of the property by the taxpayer. When evaluating whether property qualifies as "original use" property, the factors used to determine whether property qualified as new for purposes of the pre-1986 investment tax credit apply. Additional capital expenses incurred to recondition or rebuild acquired property (or owned property) would satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer would not satisfy the "original use" requirement.

Example 3: On February 1, 2002, Bob buys from Joe a $20,000 machine that had been previously used by Joe. Bob spends $5,000 on the property, making an improvement that must be capitalized. Whether the $5,000 is added to the basis of the property or is capitalized as a separate asset, that amount satisfies the "original use" requirement and is "qualified property" (assuming all other conditions are met). No part of the $20,000 purchase price qualifies for the additional 30 percent first-year depreciation.

Example 4: In 2002, Kathy purchased some cattle from her neighbor who was liquidating his dairy herd. Her purchases included some yearling heifers that were ready to be bred and some two-year old cows that were producing milk. The heifers qualify for the additional 30 percent first-year depreciation because they had not been placed in service before Kathy bought them. The cows do not qualify for the additional 30 percent first-year depreciation because they had been used in a dairy herd before Kathy bought them.

Example 5: In 2002, John bought some heifers from Jane. Jane is in the business of raising dairy cattle for sale to dairy producers. She was holding the heifers for sale in the ordinary course of business and had bred the heifers before selling them to enhance their value as dairy animals. John is likely to be allowed to claim the additional 30 percent first-year depreciation on the heifers since Jane did not hold the heifers for production of income in a trade or business.

If Jane had held the animals for use in her own dairy herd, breeding them would be treated as placing them in service. Consequently, John would not be allowed to claim the additional 30 percent first-year depreciation on the heifers since he does not meet the original use requirement.

For purposes of the original use requirement, if property (1) is originally placed in service after September 10, 2001, by a person, and (2) is sold and leased back by that person within three months after the date that the property was originally placed in service. The property is treated as originally placed in service not earlier than the date on which the property is used under the leaseback. The Joint Committee Report explains, in the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to that person by the taxpayer within three months after the date that the property was placed in service, the property is treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

Observation. As confirmed by the Committee Report's identification of "the taxpayer" as the buyer-lessor, the main effect of the sale-leaseback original use rule is to shift eligibility for additional, first-year depreciation from the seller-lessee to the buyer-lessor.

Example 6: On October 15, 2001, John, a calendar year taxpayer, buys a newly manufactured machine from manufacturer M, and begins to use the machine in his business. On January 10, 2002, John sells the machine to Mary, who is in the equipment leasing business and is a calendar-year taxpayer. Also, on January 10, 2002, John leases the machine back from Mary under a lease, the term of which begins on January 10, 2002. John continues to use the machine in John's business. Thus, January 10, 2002, is the date that the machine is first used under the leaseback, and satisfies the original use requirement. Therefore, if the machine meets the other requirements for being "qualified property," and if Mary does not "elect out," Mary is allowed additional first-year depreciation for the machine in 2002. John is not allowed additional first-year depreciation for the machine in either 2001 or 2002.

Acquisition and Placed-In-Service Requirements for Additional 30 percent First-Year Depreciation

Eligible property must be timely acquired and timely placed in service.

Acquisition requirement. "Qualified property" must meet one of the following acquisition requirements:

- Acquired by the taxpayer after September 10, 2001, and before September 11, 2004, but only if no written binding contract for the acquisition was in effect before September 11, 2001.
- Acquired by the taxpayer under a written binding contract that was entered into after September 10, 2001, and before September 11, 2004.

Example 7: Michelle purchased a tractor on September 5, 2001, and a disc on September 15, 2001. She had signed a contract to purchase the disc on September 3, 2001. Michelle cannot claim the additional 30 percent first-year depreciation on the tractor because it was purchased before September 11, 2001. She cannot claim the additional 30 percent first-year depreciation on the disc because it was subject to a binding contract before September 11, 2001.

Example 8: Fred purchased a two-month old bull on September 5, 2004, for use in his breeding herd. Since the bull is not ready to be placed in service before January 1, 2005, Peter cannot claim the additional 30 percent first-year depreciation on the bull even though it was purchased before September 11, 2004.

Property does not qualify for the additional 30 percent first-year depreciation if it is listed property used 50 percent or less in a trade or business.

Example 9: Darla purchased a pickup truck in 2002 to be used 40 percent in her farming business and 60 percent for personal use. She cannot claim the additional 30 percent first-year depreciation on the pickup.

For a taxpayer manufacturing, constructing, or producing property for the taxpayer's own use, the requirements (discussed above) are treated as met if the taxpayer begins manufacturing, constructing, or producing the property after September 10, 2001, and before September 11, 2004.

Property is considered manufactured, constructed, or produced by the taxpayer if it is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into before the manufacturing, construction, or production of the property.

Placed-in-service requirement. To be "qualified property," the property generally must be placed in service by the taxpayer before January 1, 2005. However, otherwise qualifying property may be placed in service before January 1, 2006, if:

- It has a recovery period of at least 10 years or is "transportation property" (tangible personal property used in the trade or business of transporting persons or property).

- It is subject to the uniform capitalization rules (which requires that property have an estimated production period exceeding two years) or has an estimated production period exceeding one year and a cost exceeding $1,000,000)

Qualifying pre-2006 property (i.e., property eligible for the extended placed-in-service date) is eligible for additional 30 percent first-year depreciation only to the extent of the adjusted basis attributable to manufacture, construction, or production before September 11, 2004.

Election Out

Taxpayers are treated as claiming the additional 30 percent first-year depreciation unless they elect out of the provision. The election out is made on a class-by-class basis. The Form 4562 instructions (revised March 2002) tell taxpayers to attach a statement to the tax return that indicates the classes of property for which the taxpayer is electing not to claim the additional 30 percent first-year depreciation. The election must be made by the due date (including extensions) of the tax return for the year in which the "qualified property" was placed in service. If the tax return was timely filed without the election, the taxpayer has six months after the due date of the return to file an amended return and make the election.

Example 10: Linda from the previous example could elect out of the additional 30 percent first-year depreciation by attaching a statement to her 2002 income tax return saying that she is making the election out for all property in the seven-year class. The effect of the election is to reduce the total depreciation deduction for 2002, but to increase depreciation deductions for subsequent years since the adjusted basis of the tractor for computing depreciation for those years is $50,000 rather than $35,000.

If Linda did not attach that election to her return, she could file an amended return within six months of the due date of the original return (excluding extensions) to make the election out.

Observation. If Linda neither claims the additional 30 percent first-year depreciation nor "elects out" of the additional 30 percent first-year depreciation, she must reduce her basis by the additional 30 percent first-year depreciation. That reduction will affect calculations such as her depreciation for subsequent years and her gain or loss on a subsequent sale of the tractor.

First-Year Depreciation Dollar Cap for New Passenger Autos Raised by $4,600

The inflation-adjusted dollar caps limit the amount of depreciation that may be claimed on a passenger auto. For autos placed in service in 2002, the dollar cap on first-year depreciation (i.e., for the placed-in-service year) is $3,060.

New law. The Act directs IRS to increase by $4,600 the first-year depreciation dollar limit for a passenger auto that is "qualified property" that meets the original use, acquisition, and placed-in-service requirements.

In other words, the maximum, first-year depreciation allowance for a new passenger auto acquired and placed in service after September 10, 2001, and before 2003, and used entirely for business, is $7,660 ($3,060 plus $4,600). However, a passenger auto must be used more than 50 percent for trade or business purposes in order to be eligible for the additional first-year depreciation amount.

Listed property recapture. The additional first-year deduction allowed on "qualified property" that is "listed property" (which includes passenger autos) is taken into account for purposes of computing the recapture amount (which provides for recapture where business use of listed property is more than 50 percent in the placed-in-service year, but declines to 50 percent or less of total use after the placed-in-service year). The increased, first-year depreciation dollar limit for passenger autos applies for property placed in service after September 10, 2001, in tax years ending after that date.

Temporary Increase in NOL Carry-Back Period

In general, a NOL may be carried back two years (three years for NOLs arising from casualty or theft losses of individuals or from certain presidential disaster areas) and carried forward 20 years. The carry-back period may be waived.

The Act increases the two- and three-year carry-back periods to five years for NOLs arising in tax years ending in 2001 or 2002. A taxpayer may irrevocably elect, in the manner prescribed by IRS, to forgo the five-year carry-back period and instead carry the NOL back two years (or three years, if applicable) and forward 20 years.

Consider waiving the five-year carry-back period if the taxpayer was in a low bracket in the fifth, fourth, and third years back and expects to be in higher brackets going forward. A taxpayer in this situation should also consider waiving the two-year (or three-year) carry-back period if the taxpayer was in a low bracket in the preceding two or three years. The statute literally requires two waiver elections in a situation like this, one for the five-year period and another for the two- or three-year period. Whether IRS develops a procedure for making a single waiver of both periods remains to be seen. Taxpayers should bear in mind that a waiver of the carry-back period also applies for AMT purposes

Farming loss. While the Act allows a temporary, five-year carry-back for all taxpayers for tax years 2001 and 2002, the carry-back period for a farming loss, occurring in any year after 1997, is five years. A farming loss is the smaller of the following:

- The amount that would be the NOL for the tax year if only income and deductions attributable to farming businesses were taken into account.
- The NOL for the tax year.

Temporary Waiver of Limitation on Use of NOLs Against AMT

Under the AMT rules, an alternative tax-net operating loss (ATNOL) deduction (the taxpayer's NOL deduction computed with certain adjustments set forth) cannot reduce a taxpayer's AMTI by more than 90 percent of the AMTI.

New law. Under the Act, an ATNOL attributable to (1) NOL carry-backs arising in tax years ending in 2001 or 2002, or (2) NOL carry forwards to tax years ending in 2001 and 2002 may offset 100 percent of a taxpayer's AMTI.

Thus, for example, a NOL in a tax year ending in 2001 would be carried back to 1996 (under the Act's five-year rule discussed above) and be taken into account in arriving at the taxpayer's ATNOL for 1996, and the ATNOL could fully offset the taxpayer's AMTI for 1996.

Electronic Filing of Form 1099s

Many code provisions require entities to file information returns with IRS and provide copies to taxpayers. Temporary regulations allow Form W-2 to be furnished electronically on a voluntary basis. A similar administrative rule cannot be implemented for some information returns, because the code requires that the copies be furnished to individuals either in person or a statement sent by first-class mail in a specified format.

New law. Effective March 9, 2002, the Act removes the statutory impediment to providing copies of specified information returns to taxpayers electronically. Accordingly, for any tax year ending after March 9, 2002 (date of enactment), these copies may be furnished electronically to recipients who consent. The copies may be furnished in a manner similar to the one permitted for Form W-2s or in another manner provided by IRS.

Individual Tax Provisions

Adoption Tax Credit Clarification

Before changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the maximum amount of adoption expenses considered when computing the adoption tax credit for any child was $5,000 ($6,000 for special needs adoptions). For expenses paid or incurred in a tax year before an adoption becomes final, the credit generally is allowed in the tax year after expenses are paid or incurred. EGTRRA increased the maximum amount of credit-eligible expenses to $10,000 for tax years beginning after 2001, but did not include a provision describing the dollar limit for amounts paid or incurred during tax years beginning before 2002, for adoptions that did not become final in those years.

New law. The Act clarifies that the amount of expenses paid or incurred during tax years beginning before 2002 that are taken into account in determining an adoption credit allowed in a tax year beginning after 2001, are subject to the $5,000 (or $6,000) dollar cap in effect immediately prior to the enactment of EGTRRA.

Special Needs Adoptions

The Act also clarifies that for special-needs adoptions that become final in tax years beginning after 2002, the adoption expenses taken into account are increased by the excess (if any) of $10,000 over the aggregate adoption expenses for the tax year the adoption becomes final and all prior tax years. Under prior law it was not clearly specified that aggregate adoption expenses reduced the $10,000 amount. A similar clarification is made for the employer-provided adoption assistance exclusion for special needs adoptions.

No More Double Tax Breaks for Insolvent S Corporations

If an S corporation is in bankruptcy or is insolvent, any income from the discharge of debt by its creditors is excluded from its income, and the S corporation reduces its tax attributes (including losses suspended because the S shareholder has insufficient basis to make present use of them).

Example 11: Linda is the sole shareholder of an S corporation and she has a zero basis in its stock. The S corporation borrows $100,000 from a bank and loses the entire amount. Because Linda has no basis in its stock, the $100,000 loss is "suspended" at the corporate level. The $100,000 debt is forgiven when the corporation is insolvent. The $100,000 income from the discharge of indebtedness is excluded from the corporation's income. Under the Supreme Court's decision in Gitlitz, (S Ct 1/9/2001) 87 AFTR 2d 2001-417, the $100,000 is treated as an item of income that increases the basis of Linda's stock in the S corporation. This, in turn, permits her to deduct the suspended loss.

New law. The Act overrules Gitlitz by providing that income from the discharge of debt of an S corporation excluded from its income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation. The change generally applies to debt discharges after October 11, 2001. It does not apply to any debt discharge before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.

Clarification to Deemed-Sale Election to Recognize Gain on Assets Held on January 1, 2001

A non-corporate taxpayer's gain from the sale or exchange of property held for more than five years for a period beginning after December 31, 2000, which would otherwise be taxed at a 20 percent rate, will be taxed at an 18 percent rate. Under the deemed-sale-and-repurchase election, a non-corporate taxpayer may elect to treat a capital asset or property used in a trade or business and held by the taxpayer on January 1, 2001, as having been sold on that date for its fair market value (FMV), and reacquired on that date for that FMV. Any gain resulting from this deemed sale-and-repurchase election is recognized "notwithstanding any provision" of the code. Once made, the deemed-sale-and-repurchase election is irrevocable.

Internal Revenue Code Section 121 provides that a taxpayer who sells his or her principal residence may exclude up to $250,000 of gain (up to $500,000 for qualifying married taxpayers filing jointly) if he or she owned the home and used it as a principal residence for at least two of the five years preceding the sale. The full exclusion is available only if the taxpayer did not use the exclusion on a previous home sale within the two-year period ending on the sale date.

New law. The Act clarifies that the exclusion of gain on the sale of a principal residence under Internal Revenue Code Section121 does not apply for an asset for which the deemed-sale election is made.

Also, a deemed-sale election for an interest in a passive activity does not result in the deduction of suspended passive activity losses. However, any gain taken into account by reason of such an election for an interest in a passive activity is taken into account in determining the passive activity loss for the tax year.

Enhanced Exclusion for Qualified Foster Care Payments

Qualified foster care payments paid to a foster care provider by either a state or local government or a tax-exempt placement agency, are excluded from gross income

Qualified foster care payments are amounts paid for caring for a qualified foster care individual in the foster care provider's home and 'difficulty of care' payments.

A qualified foster care individual is an individual living in a foster care family home in which the individual was placed by:

- An agency of the state or local government (regardless of the individual's age at the time of placement); or
- A tax-exempt placement agency licensed by the state or local government (if such individual was under the age of 19 at the time of placement).

New law. For tax years beginning after December 31, 2001, the Act makes two modifications to the exclusion: (1) it expands the definition of qualified foster care payments to include payments by any placement agency that is licensed or certified by a state or local government, or an entity designated by a state or local government to make payments to providers of foster care; and (2) it expands the definition of a qualified foster care individual by including foster care individuals placed by a qualified foster care placement agency (regardless of the individual's age at the time of placement).

New 2002-2003 Above-the-Line Deduction for Educators Who Buy Classroom Materials

Un-reimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income (AGI). Miscellaneous itemized deductions may be reduced under Internal Revenue Code Section 68 if the taxpayer's AGI exceeds an inflation-adjusted figure ($137,300 for 2002) and are not allowable for purposes of computing the AMT.

New law. For 2002 and 2003, the Act provides an annual above-the-line deduction for up to $250 of expenses paid or incurred by an eligible educator for books, supplies (other than non-athletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services), other equipment, and supplementary materials used by him/her in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under Internal Revenue Code Section162 as a trade or business expense.

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, or principal in a school for at least 900 hours during a school year. A school means any school that provides elementary education or secondary education, as determined under state law. Eligible educators should keep receipts for expenses eligible for the deduction. The above-the-line deduction for classroom materials expenses is effective for tax years beginning after 2001 and before 2004.

Retirement Plan Clarifications

Elective deferrals not taken into account for deduction limits

The Act clarifies that elective deferrals to a SEP are not subject to the SEP deduction limits and are not taken into account in applying the limits to other SEP contributions. It also clarifies that the combined deduction limit of 25 percent of compensation for qualified defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.

SEP income inclusion

Under pre-Act law, contributions to a SEP generally are included in an employee's income to the extent they exceed the lesser of 15 percent of compensation or $40,000 (for 2002). That 15 percent limit reflects the annual limitation on the amount of deductible SEP contributions before EGTRRA raised the contribution percentage limit to 25 percent.

New law. The Act increases the annual limitation of deductible SEP contributions from 15 percent of compensation to 25 percent. It also makes a conforming change so that SEP contributions are included in an employee's income only to the extent they exceed the lesser of 25 percent of compensation or $40,000 for 2002.

Catch-up contributions

An individual aged 50 or over may make additional elective deferrals (catch-up contributions) to certain retirement plans, up to a specified limit. A plan may not permit catch-up deferrals in excess of this limit.

New law. The Act clarifies that, for this purpose, the limit applies to all qualified retirement plans, tax-sheltered annuity plans, SEPs, and SIMPLE plans maintained by the same employer on an aggregated basis, as if all plans were a single plan.

The Act also clarifies that an individual who will turn age 50 by the end of the tax year may make catch-up contributions at any time during that year rather than waiting until age 50.

EXTENDERS

Alternative Minimum Tax Relief for Individuals

For tax years beginning in 2001, all the nonrefundable, personal credits are allowed to the extent of the full amount of the individual's regular tax and AMT. Under pre-Act law, for tax years beginning after 2001, these credits (other than the adoption credit, child credit, and low-income taxpayer's retirement savings credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and IRA credit are allowed to the full extent of the individual's regular tax and AMT.

New law. The Act allows an individual to offset the entire regular tax liability and AMT liability by the personal nonrefundable credits in 2002 and 2003.

This elimination of the credit limitation for 2002 will save taxes both for taxpayers who will owe AMT for 2002 and for

those who will not owe AMT for this year. The limitation would prevent nonrefundable credits from being used against AMT and could prevent some of those credits from being used against regular tax liabilities for individuals whose regular tax ends up being not much more than their tentative AMT.

Work Opportunity Credit Revived and Extended

The work-opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit equals 40 percent (25 percent for employment of less than 400 hours) of qualified wages. The maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages), except that it is $1,200 (40 percent of the first $3,000 of qualified first-year wages) for qualified summer youth employees. The credit applies for wages paid or incurred to a qualified individual who began work for an employer before January 1, 2002.

New law. The Act extends the work opportunity tax credit for two years so that it applies for wages paid before January 1, 2004.

Welfare-To-Work Credit Revived and Extended

The welfare-to-work credit is available on an elective basis for employers for the first $20,000 of eligible wages paid to qualified, long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages the first year of employment and 50 percent of the first $10,000 of eligible wages the second year of employment. The maximum credit is $8,500 per qualified employee. The credit applies for wages paid or incurred to a qualified individual who began work for an employer before January 1, 2002.

New law. The Act extends the welfare-to-work credit for two years so that it applies for wages paid before January 1, 2004.

Credit for Purchase of Electric Vehicles Extended

A 10 percent tax credit applies for the cost of a qualified electric vehicle, up to a maximum credit of $4,000. A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current. The original use commences with the taxpayer, and is acquired for use by the taxpayer and not for resale. The full credit amount is available for purchases before 2002. The credit decreases in 2002 through 2004 and is unavailable for purchases after December 31, 2004.

New law. The Act defers the phase down of the credit for two years. Thus, taxpayers may claim the full amount of the credit for qualified purchases made in 2002 and 2003. The phase down now commences in 2004 with the credit being unavailable for purchases after December 31, 2006.

Alternative Energy Credits Revived and Extended

A credit is allowed for the production of electricity from qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities. The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2002; to electricity produced by a "closed-loop" biomass facility placed in service after December 31, 1992, and before January 1, 2002; and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2002. The credit is allowable for production during the 10-year period after a facility is originally placed in service.

New law. The Act extends the service date for qualified facilities by two years to include facilities placed in service before January 1, 2004.

Deduction for Qualified Clean Fuel Vehicle and Qualified Clean Fuel Vehicle Refueling Property Extended

Certain costs of qualified, clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when the property is placed in service. Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels. The maximum deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with a seating capacity of at least 20 adults, $5,000 for a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds, and $2,000 for any other motor vehicle. The deduction for clean-fuel vehicle property phases down in the years 2002 through 2004 and is unavailable for purchases after December 31, 2004.

Clean-fuel vehicle refueling property is property for the storage or dispensing of a clean-burning fuel at the point where the fuel is delivered into the fuel tank of a motor vehicle. It also includes property for the recharging of electric vehicles located at a point where the electric vehicle is recharged. Up to $100,000 of clean-fuel refueling property at each location owned by the taxpayer may be expensed. The deduction for clean-fuel vehicle refueling property is unavailable for property placed in service after December 31, 2004.

New law. The Act defers the phase down of the deduction for clean-fuel vehicle property by two years so that taxpayers may claim the full amount of the deduction for qualified vehicles placed in service in 2002 and 2003. Under the Act, the deduction for clean-fuel vehicles phases down in 2004 and 2005 with the deduction being unavailable for purchases after December 31, 2006.

Suspension of Taxable Income Limit on Percentage Depletion for Marginal Producers Extended

Generally, only independent producers and royalty owners may claim the percentage depletion method. Under this method, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is deducted in each tax year. The amount deducted may not exceed 100 percent of the net income from that property in any year. The Taxpayer Relief Act of 1997 suspended this net income limitation for production from marginal wells for tax years beginning after December 31, 1997, and before January 1, 2000. The limitation subsequently was extended to include tax years beginning before January 1, 2002.

New law. The Act extends the period when the 100 percent net-income limit is suspended to include tax years beginning in 2002 and 2003.

Authority to Issue Qualified Zone Academy Bonds Extended

As an alternative to traditional tax-exempt bonds, states and local governments may issue "qualified zone academy bonds." Financial institutions that hold them are entitled to a nonrefundable tax credit equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified, zone academy bond on the credit allowance date is entitled to a credit, which is included in gross income (as if it were a

taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability. A total of $400 million of qualified zone academy bonds was authorized to be issued annually in calendar years 1998 through 2001.

New law. The Act authorizes issuance of up to $400 million of qualified zone academy bonds annually in calendar years 2002 and 2003.

Archer Medical Savings Account Program Extended

Contributions to an Archer Medical Savings Account (MSA) are deductible when determining adjusted gross income if made by an eligible individual, and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on an Archer MSA are not currently taxed. Distributions for medical expenses are not taxed. Expenses used for other purposes are taxed and are subject to a 15 percent penalty tax unless made after age 65, death, or disability. After 2002, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer.

Tax Incentives for Investment on Indian Reservations Extended

Special tax incentives exist to encourage investment on Indian reservations including an Indian employment credit and accelerated depreciation of property on Indian reservations. The credit, which is allowed to an employer of qualified employees that work on an Indian reservation, equals 20 percent of the excess of qualified wages and health insurance costs paid to qualified employees in the current year over the amount paid in 1993, up to a maximum of $20,000. The credit is not available after December 31, 2003. Accelerated depreciation is allowed for property on Indian reservations, but is not available for property placed in service after December 31, 2003.

New York Liberty Zone Tax Benefits

The Act contains a number of tax benefits for businesses in the New York Liberty Zone area that was affected by the September 11, 2001, terrorist attack. The Liberty Zone is the area of Manhattan located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway). These special tax benefits are described in the following paragraphs.

Additional 30 percent First-year Depreciation

The cost of most types of depreciable property is recovered by the MACRS depreciation rules. The recovery period and recovery method (straight-line or accelerated depreciation) are determined by the asset class of the property. For most property (other than buildings) depreciated under MACRS, Internal Revenue Code Section 56 requires that depreciation deductions be calculated, for purposes of determining AMTI, on the 150 percent declining balance method. Pre-Act law does not provide an additional, first-year depreciation allowance for any type of property.

New law. The Act allows an additional, 30 percent first-year depreciation deduction for depreciable qualified New York Liberty Zone (Liberty Zone) property; the bonus depreciation allowance applies for both regular and AMT purposes. As with the regular 30 percent bonus depreciation in the Act, the basis of the property and the depreciation allowances must be appropriately adjusted to reflect the additional first-year depreciation deduction. Taxpayers may elect out of the additional first-year depreciation for any class of property for any tax year.

To qualify, property must be depreciable under the MACRS rules (i.e., not property that must be depreciated under the alternative depreciation system of MACRS on a straight-line basis over its ADS useful life), and must meet one of the following requirements:

- Have a recovery period of 20 years or less.
- Be water utility property.
- Be qualified leasehold improvement property.
- Be computer software other than software with a five year cost recovery period.

Practitioner observation. These are the same types of property that qualify for the new additional 30 percent first-year depreciation allowance.

The property must be acquired by purchase by the taxpayer after September 10, 2001, (and not pursuant to a pre-September 11, 2001, binding written contract) and be placed in service before January 1, 2007 (before January 1, 2010, for qualifying nonresidential real property and residential property). In addition, the property's first use in the Liberty Zone must begin with the taxpayer after September 10, 2001, (used property may qualify), and substantially all of its use must be in the Liberty Zone. Improvements to recondition or rebuild property in the Liberty Zone satisfy the original-use requirement.

The 30 percent depreciation acceleration is not available for:

- Qualified New York Liberty Zone leasehold improvement property.
- Property eligible for the Act's general additional, 30 percent first-year depreciation.

On the one hand, the Act provides that the Liberty Zone's extra 30 percent first-year depreciation allowance applies to the same types of property eligible for the general, additional 30 percent first-year depreciation allowance. On the other hand, it prevents property eligible for the general extra 30 percent write-off from being eligible for the Liberty Zone extra 30 percent first-year depreciation allowance. One reason the Act is structured in this way is to allow taxpayers to claim the Liberty Zone extra 30 percent first-year depreciation allowance for the four classes of property enumerated above that are acquired by purchase after September 10, 2004, and placed in service before 2007.

Nonresidential real property and residential rental property qualify for the bonus depreciation only to the extent that it rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of, the terrorist attacks of September 11, 2001.

Rapid Depreciation for Qualified Liberty Zone Leasehold Improvements

New law. The Act allows the cost of qualified leasehold improvement property (certain improvements to an interior portion of an existing nonresidential building, that is Liberty Zone property to be depreciated on a straight-line basis over five years (nine years under the alternative depreciation system). The property must be located in the Liberty Zone and be placed in service after September 10, 2001 (not pursuant to a binding written agreement in effect before September 11, 2001), and before 2007.

Increased Expensing for Liberty Zone Property

Businesses that do not put more than $200,000 of personal property in service in a year may elect to expense up to $24,000 of its cost ($25,000 for post-2002 years). That maximum amount is phased out dollar-for-dollar if higher amounts of property are placed in service in a tax year.

New law. The Act increases the amount that can be expensed for property used in the Liberty Zone. The regular maximum expensing allowance ($24,000 for eligible property placed in service in tax years beginning in 2001 or 2002, $25,000 after 2002) is increased by $35,000 for qualified Liberty Zone property. The original use of the property in the Liberty Zone must commence with the taxpayer after September 10, 2001; the property must be acquired by the taxpayer by purchase after September 10, 2001, and must be placed in service before 2007. Substantially all of the use of the property must be in the Liberty Zone in the active conduct of the trade or business of a taxpayer in that zone. The phase out of the expensing limit is applied taking into account only half of the cost of expensing-eligible qualified zone property.

Extended Replacement Period for Involuntarily Converted Liberty Zone Property

A taxpayer may elect under Internal Revenue Code Section1033 not to recognize gain on property that is involuntarily converted by acquiring and placing in service, within a two-year period after the close of the year of the conversion, property that is similar or related in service or use. The replacement period is three years if the converted property is investment or business real property. For a principal residence converted in a presidential-declared disaster, the replacement period is four years. For investment or business property involuntarily converted in a presidential-declared disaster, any tangible property acquired and held for use in a business is treated as similar or related in service or use to the converted property.

New law. The Internal Revenue Code Section1033 replacement period for property involuntarily converted in the Liberty Zone as a result of the September 11 terrorist attack is extended to five years from the current two, three, or four years, but only if substantially all of the replacement property is in New York City.

Thus, the replacement property does not have to be located within the Liberty Zone to qualify for the longer replacement period as long as substantially all of it is in New York City.

Expanded Work Opportunity Tax Credit for Small Liberty Zone Employers

Employers who hire members of certain targeted groups (such as families eligible to receive certain assistance benefits and SSI benefit recipients) may claim a work opportunity tax credit (WOTC) of 40 percent of up to $6,000 of a target-group employee's first-year wages (or 25 percent if the employee works between 120 and 400 hours; nothing if less than 120 hours). A smaller credit is available for certain summer youth employees. The employer's deduction for wages is reduced by the amount of the credit claimed.

New law. The Act creates a new targeted group of WOTC-eligible individuals—employees who perform substantially all their services in the Liberty Zone (or elsewhere in New York City, if the business was forced to relocate as a result of the physical destruction or damage of the place of business by the September 11 terrorist attack) for a business employing an average of 200 or fewer employees on business days during the tax year.

For the new-targeted group, the credit is not limited to a percentage of first-year wages. Rather, the credit is 40 percent of up to $6,000 of wages paid or incurred for work performed for the employer in each of calendar year 2002 and 2003. The credit is available in tax years ending after December 31, 2001 for wages paid during those two calendar years. The WOTC attributable to the Liberty Zone targeted group is allowed in full against the AMT.

Unlike other WOTC targeted categories, the credit for Liberty Zone employees is available for wages paid to both new hires and existing employees. For a business that relocated from the Liberty Zone to other locations within New York City due to terrorist-related damage or destruction of their workplaces within the zone, the number of employees whose wages are eligible for the WOTC as Liberty Zone employees cannot exceed the number of its employees in the Liberty Zone on September 11, 2001.

Unlike other targeted categories, members of the Liberty Zone targeted group will not have to be certified as group members by a State Employment Security Agency.

Private Activity Bond Authorization for Rebuilding the Liberty Zone

New law. The Act authorizes issuance during calendar years 2002, 2003, and 2004 of an aggregate amount of $8 billion of tax-exempt private activity bonds to finance the construction and rehabilitation of certain nonresidential real property and residential rental real property in a newly designated Liberty Zone of New York City. Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements, and public utility property (e.g., gas, water, electric, and telecommunication lines).

If it is determined that it is not feasible to use all of the authorized bond proceeds, up to $2 billion of them may be designated by the New York Governor and New York City Mayor to be used for the acquisition, construction, and rehabilitation of certain commercial real property located outside the Zone and within New York City.

Additional Advance Refunding of Previously Refunded Bonds for New York City Facilities

A refunding bond is used to redeem a prior tax-exempt bond issuance. Tax-exempt bonds may be refunded currently

(when the refunded debt is redeemed within 90 days of the issuance of the refunding bonds) an indefinite number of times. Governmental bonds and qualified Internal Revenue Code Section 501(c)(3) bonds also may be advance refunded one time. An advance refunding occurs when the refunded debt is not redeemed within 90 days after the refunding bonds are issued. Rather, proceeds of the refunding bonds are invested in an escrow account and held until a future date when the refunded debt may be redeemed.

New law. The Act permits up to $9 billion of certain bonds for facilities located in New York City to be advance refunded one additional time. These bonds include only bonds for which all pre-Act advance refunding authority was exhausted before September 12, 2001, and with respect to which the advance refunding bonds authorized under pre-Act law were outstanding on September 11, 2001. Further, to be eligible for the additional advance refunding, at least 90 percent of the refunded bonds must have been used to finance facilities located in New York City, and the bonds must be issued by (1) New York City (general obligation bonds), (2) New York State Metropolitan Transportation Authority, (3) New York Municipal Water Finance Authority, or (4) be issued by or on behalf of New York State or New York City to finance certain non-profit hospital facilities. The provision is effective on March 9, 2002 and before January 1, 2005.

Summary

The "Job Creation and Worker Assistance Act of 2002," signed into law in March 2002, mostly benefits businesses and investors. Several changes are retroactively effective and may affect returns that have already been filed as well as those that are about being filed for tax year 2001. There are several changes affecting individuals as well.

Tax breaks for businesses and investors include the following changes:

- An additional, 30 percent first-year depreciation write-off for most types of new non-realty property acquired after September 10, 2001, and before September 11, 2004. For example, if a business bought a new qualifying $10,000 machine normally depreciated over five years, the first-year write-off under the new law is $4,400. Under prior law, the maximum first-year write-off is only $2,000. The extra 30 percent first-year write-off also applies to certain types of interior improvements to leased nonresidential realty (such as an office building or factory).
- The first-year depreciation dollar cap on new luxury autos bought for business purposes is boosted by $4,600, effective for autos acquired after September 10, 2001, and before September 11, 2004. For qualifying autos bought in 2001 or 2002 a maximum first-year write-off is $7,660 (regular $3,060 first-year allowance plus $4,600). This means a larger up-front deduction for those who buy new autos for use in their business. The auto must be used more than 50 percent for business, and the full benefit of the increased dollar cap is available only if the auto is used exclusively for business.
- The NOL carry-back period is increased from two or three years to five years, for NOLs arising in tax years ending in 2001 or 2002. This change could create additional refunds for businesses suffering losses. Related changes help businesses with NOLs avoid AMT problems.
- Many tax breaks that expired at the end of 2001 are retroactively reinstated and extended for two years. These include the work opportunity tax credit and the welfare-to-work credit.
- Businesses operating in lower Manhattan that suffered as a result of the September 11 terrorist attacks are given a package of five new tax breaks.

Tax changes for individuals include the following provisions:

- A two-year reprieve from an onerous rule that would have reduced an individual's personal nonrefundable credits (such as education credits) because of the AMT. Under the new law, for 2002 and 2003, personal nonrefundable credits cab be used to offset both regular tax liability and AMT liability.
- A crackdown on S corporation shareholders prevents them from increasing the basis of their stock in the entity (and thereby being able to deduct suspended losses) by debt that is forgiven and excluded from the corporation's income when the entity is bankrupt or insolvent.
- A number of changes, mostly favorable, deal with the enhanced retirement savings opportunities created by the 2001 tax law. For example, a change clarifies that a person can make "catch-up" contributions any time during the year he or she turns age 50, not just after the calendar date he or she attains age 50.
- For 2002 and 2003, there's a new, up to $250 deduction for educators below the college level who spend their own money on books and other materials they use in the classroom. The new deduction is available to itemizers and non-itemizers.

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The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state, and local governments that delivers information to help people help themselves through the land-grant university system.

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