

MEMO# 26813

January 2, 2013

American Taxpayer Relief Act of 2012 Approved by Congress

[26813]

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TO: TAX MEMBERS No. 1-13

OPERATIONS MEMBERS No. 1-13

INTERNATIONAL MEMBERS No. 2-13

TRANSFER AGENT ADVISORY COMMITTEE No. 1-13

INDEPENDENT DIRECTORS COUNCIL No. 1-13 RE: AMERICAN TAXPAYER RELIEF ACT OF
2012 APPROVED BY CONGRESS

The American Taxpayer Relief Act of 2012 (“ATRA of 2012”), approved by both Houses of the U.S. Congress on January 1, 2013, contains several provisions of interest to investment companies and their shareholders. As explained in this memorandum, (1) the maximum tax rate on long-term capital gains and qualified dividend income has been increased for certain “high income individual” taxpayers; (2) the qualified five-year gain provision has been repealed permanently; (3) the backup withholding rate has been maintained at 28 percent; (4) the flow-through provisions for interest and short-term gains paid to foreign shareholders have been extended in part; and (5) the subpart F exception for active financing income has been extended.

I. Tax Rates on Long-Term Capital Gains and Qualified Dividend Income

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (“JGTRRA of 2003”) reduced the maximum tax rate on long-term capital gains to 15 percent (with lower maximum rates for certain taxpayers) and created a new type of income – “qualified dividend income” (or “QDI”) [\[1\]](#) – that would be taxed at these reduced long-term capital gains rates. These lower rates on long-term capital gains and QDI, originally scheduled to expire after 2008, were extended through 2012 by legislation enacted in 2006 [\[2\]](#) and 2010. [\[3\]](#)

The ATRA of 2012 repeals the sunset provision of the JGTRRA of 2003 [\[4\]](#) – thereby making permanent the QDI provision and, for most taxpayers, the 15-percent maximum capital gains and QDI tax rate. A new 20-percent maximum tax rate for long-term capital gains and QDI is provided, however, for certain “high income individuals” to the extent that their taxable income exceeds \$400,000 (if single), \$425,000 (if a head of household) or \$450,000

(if married filing jointly).

II. Qualified Five-Year Gain Provision Repealed Permanently

The Taxpayer Relief Act of 1997 (“TRA”) reduced the maximum capital gains rate on “qualified five-year gains” from 20 percent to 18 percent for capital gains on assets acquired after 2000 and held for more than five years. The JGTRRA of 2003 repealed the qualified five-year gain provision when it reduced the maximum capital gains tax rates below the rates provided by the TRA of 1997. The lower rates provided by the JGTRRA of 2003 were scheduled to sunset, however, after 2008 – at which point the qualified five-year gain provision again would have been applicable. The lower capital gains rates provided in 2003 were extended (and the qualified five-year gain rule remained inapplicable) until the end of 2012 by legislation enacted in 2006 [\[5\]](#) and 2010. [\[6\]](#)

The ATRA of 2012 strikes the sunset provision of the JGTRRA of 2003. [\[7\]](#) Because this sunset provision would have resurrected the qualified five-year gain provision enacted in 1997, the ATRA of 2012 effectively repeals permanently the qualified five-year gain provision.

III. Backup Withholding Rate Maintained at 28 Percent

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) reduced the rate at which backup withholding from 31 percent to “the fourth lowest rate of tax applicable under section 1(c).” Because EGTRRA added a new 10-percent tax rate, the “fourth lowest rate” was 28 percent. The backup withholding and 10-percent tax rate modifications, originally set to expire after 2010 (pursuant to the EGTRRA “sunset provision”), were extended until the end of 2012 by legislation enacted in 2010. [\[8\]](#)

The ATRA of 2012 repeals the EGTRRA of 2001 sunset provision. [\[9\]](#) Thus, the ATRA of 2012 makes permanent the 28-percent backup withholding rate.

IV. Flow-Through Provisions Extended (in Part)

The American Jobs Creation Act of 2004 (“AJCA of 2004”) amended the Internal Revenue Code [\[10\]](#) to provide an exemption from U.S. withholding taxes for amounts paid by regulated investment companies (“RICs”) to foreign shareholders attributable to interest income and short-term capital gains. The Code already provides that these amounts are exempt from U.S. withholding tax if received directly (rather than through a RIC) by such foreign shareholders. This 2004 legislation also applied to RICs certain real estate investment trust (“REIT”)-related provisions of the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA. [\[11\]](#) Finally, the 2004 legislation included a provision that effectively excluded from the U.S. estate tax shares of a RIC held by a foreign individual investor to the extent that the RIC’s assets consisted of debt instruments that produce interest income (that would be exempt from the estate tax if held directly by a foreign investor). These provisions were extended twice (in 2008 and 2010).

The ATRA of 2012 extends for two years the exemption from withholding taxes for interest-related dividends and short-term capital gain dividends [\[12\]](#) as well as the FIRPTA-related provisions. [\[13\]](#) Under the extension, these “flow-through” provisions continue to apply to

dividends with respect to taxable years of RICs beginning before January 1, 2014. The estate tax provision, however, was not extended by the ATRA. Thus, the estate tax exemption provided initially in 2004 does not apply to any decedents dying on or after January 1, 2012.

V. Active Financing Exception Extended

Finally, the ATRA of 2012 extends for two years the present-law exception from Subpart F for certain income from the active conduct of a banking, financing, or similar business or from an insurance business. [\[14\]](#) This extension applies to taxable years beginning before 2014.

Keith Lawson
Senior Counsel - Tax Law

endnotes

[\[1\]](#) Qualified dividend income is defined to include dividends received from domestic corporations and qualified foreign corporations.

[\[2\]](#) The Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”) enacted on May 17, 2006.

[\[3\]](#) The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“the Jobs Act of 2010”).

[\[4\]](#) See ATRA of 2012 section 102(a).

[\[5\]](#) TIPRA.

[\[6\]](#) The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“the Jobs Act of 2010”).

[\[7\]](#) See ATRA of 2012 section 102(a).

[\[8\]](#) The Jobs Act of 2010.

[\[9\]](#) See ATRA of 2012 section 101(a).

[\[10\]](#) Code sections 871(k)(1) and (2).

[\[11\]](#) Code section 897.

[\[12\]](#) See ATRA of 2012 section 320.

[\[13\]](#) See ATRA of 2012 section 321.

[\[14\]](#) See ATRA of 2012 section 322.

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