

MEMO# 19404

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SENATE APPROVES S. 2020, THE "TAX RELIEF ACT OF 2005"

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [19404] November 23, 2005 TO: ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 14-05 TAX MEMBERS No. 31-05 RE: SENATE APPROVES S. 2020, THE "TAX RELIEF ACT OF 2005" The Senate has approved S. 2020, the "Tax Relief Act of 2005" (the "Bill").¹ The House of Representatives is considering similar legislation, H.R. 4297, the "Tax Relief Extension Reconciliation Act of 2005." One provision under active consideration that was not included in the Bill is a two-year extension of the 15 percent maximum tax rate on long term capital gains and qualified dividend income. This provision presently is scheduled to expire after 2008. The Bill includes a number of provisions of interest. 1. Application of FIRPTA to Regulated Investment Companies The Bill would modify the application of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") to foreign shareholders in U.S. regulated investment companies ("RICs"). Any foreign shareholder with income subject to FIRPTA ("FIRPTA gain") is required to file a U.S. tax return and pay tax (like U.S. resident taxpayers) based upon reportable income; withholding agents are required to withhold tax on FIRPTA gains at a 35 percent rate. We are pleased to inform you that, as urged by the ICI, the Bill would limit FIRPTA's application. Under section 563 of the Bill, a RIC would be a qualified investment entity (which is a trigger for FIRPTA application) only if, in general, more than half of its assets were invested directly or indirectly in U.S. real property. This change would be effective for distributions with respect to taxable years beginning after December 31, 2004. In addition, under section 564 of the Bill, distributions by a RIC that is a qualified investment entity, with respect to its publicly traded stock, would not be FIRPTA gain (if the gain were attributable to the sale or exchange of U.S. real property) unless the foreign shareholder owned more than five percent of the RIC stock at any time during the one-year period ending on the date of such distribution. Instead, the gain would be treated as ordinary income. The Bill also would extend FIRPTA in certain respects. Section 564 of the Bill would ensure that FIRPTA applies to a distribution by a qualified investment entity to the extent that 1 The Bill as passed by the Senate is not currently available online. Go to <http://thomas.loc.gov/> and search by bill number to check for publication of the most recent version of S. 2020. 2 the distribution is attributable to FIRPTA gain included in a capital gain dividend received from an investment by this "upper-tier entity" in a "lower-tier" qualified investment entity. This change would apply to taxable years of qualified investment entities beginning after the date of enactment. Section 565 of the Bill also would treat as FIRPTA gain certain amounts realized by a foreign investor disposing of and then reacquiring an interest in a domestically-controlled qualified investment entity in an "applicable wash sale transaction." Specifically, any gain on the disposition of the interest in the qualified investment entity would be

FIRPTA gain to the extent that gain subject to FIRPTA would have been realized had the investor retained the investment in the qualified investment entity. The Bill would not apply wash sale transaction treatment in two situations. First, this treatment would not apply if the investor actually received the distribution. Second, this treatment would not apply if the investor disposed of shares in a qualified investment entity that is regularly traded on an established securities market within the U.S., provided that the investor did not own more than five percent of such stock at any time during the one-year period ending on the date of the distribution. Under the Bill, withholding would not be required with respect to an applicable wash sale transaction. The FIRPTA wash sale rule would apply after December 31, 2005, in taxable years ending after such date.

2. Donor Advised Funds The Bill would provide a new statutory regime for donor advised funds. This regime would include requirements involving substantiation, distribution, valuation and reporting. The donor advised fund rules are described in detail in an attached memorandum.

3. Information Reporting Requirements on Tax-Exempt Bonds Section 558 of the Bill would amend the information reporting rules so that interest paid on tax-exempt bonds would be subject to information reporting in the same manner as interest paid on taxable bonds. The provision would be effective for tax-exempt interest earned after December 31, 2005.

4. Denial of Deductions for Certain Fines, Penalties and Other Amounts Section 533 of the Bill would expand the scope of section 162(f), which denies deductibility of fines or similar penalties paid to a government. Under the Bill, deductibility would be denied for “any amount paid . . . to, or at the direction of, a government entity or [certain self-regulatory organizations (“SROs”)] in relation to the violation of any law or the investigation or inquiry . . . into the potential violation of any law.” An exception (permitting deductibility) would be provided in the Bill for any payment “which the taxpayer establishes constitutes restitution . . . for damage or harm caused by or which may be caused by the violation of any law or the potential violation of any law” (but not including any amounts paid as reimbursement for the costs of investigation or litigation). A second exception (permitting deductibility) would be provided for payments made pursuant to a court order where no government or relevant SRO is a party to the action.

3 The provision would be effective for payments made on or after the date of enactment, except it would not apply to any payments made pursuant to a binding order or agreement entered into before the date of enactment.

5. Other Provisions The Bill contains other provisions that may be of interest. Section 551 of the Bill would modify the rules for valuing contingent convertible debt for purposes of computing original issue discount (“OID”). The provisions would require that “any regulations which require [OID] to be determined by reference to the comparable yield of a noncontingent fixed-rate debt instrument be applied as if the regulations require that such comparable yield be determined by reference to a noncontingent fixed-rate debt instrument which is convertible into stock.” The provision also would require that comparable yield be determined without taking into account the yield resulting from the conversion of a debt instrument into stock. The provision would be effective for debt instruments issued on or after the date of enactment. Section 557 of the Bill would impose new requirements on pooled financing bonds as a condition for tax-exemption, including (i) a written loan requirement to identify potential borrowers of at least 50 percent of the net proceeds; (ii) the issuer’s reasonable expectation that at least 50 percent of the net proceeds of the pooled bond will be loaned to borrowers on or before one year after the date of issue and at least 95 percent of the net proceeds of the pooled bond will be loaned to borrowers on or before three years after the date of issue; and (iii) the redemption of outstanding bonds with proceeds that are not loaned to borrowers within certain deadlines. The provision would be effective for bonds issued after the date of the enactment of this Act.

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Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and

search for memo 19404, or call the ICI Library at (202) 326-8304 and request the attachment for memo 19404.

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