MEMO# 20024

May 12, 2006

Congress Passes H.R. 4297, The "Tax Increase Prevention and Reconciliation Act of 2005"

 [20024] May 12, 2006 TO: ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 6-06 INTERNATIONAL MEMBERS No. 8-06 OPERATIONS MEMBERS No. 12-06 PENSION MEMBERS No. 36-06 TAX MEMBERS No. 15-06 RE: CONGRESS PASSES H.R. 4297, THE "TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005" We are pleased to inform you that Congress has passed H.R. 4297, the "Tax Increase Prevention and Reconciliation Act of 2005" (the "Act").1 The Act contains several provisions of interest, including two actively pursued by the ICI. Specifically, the Act extends for two years the reduced tax rates on long-term capital gains and qualified dividends and retroactively limits the application of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") to regulated investment companies ("RICs"). 1. Extension of Reduced Tax Rates on Long-Term Capital Gains and Dividends The Act extends for two additional years (through 2010) the 15 percent maximum tax rate on long-term capital gains and qualified dividend income.2 These reduced rates, enacted in 2003 by the Jobs and Growth Tax Relief Reconciliation Act3, had been scheduled to expire after 2008. Under current law, the 5% rate goes to zero in 2008. The Act retains this zero rate for 2009 and 2010. 1 Go to http://finance.senate.gov/sitepages/leg/leg050906.pdf to read the Act. 2 Section 102 of the Act. 3 See Institute Memorandum (16113) to Tax Members No. 31-03, Accounting/Treasurers Members No. 28-03, Operations Members No. 16-03, International Members No. 18-03 and Transfer Agent Advisory Committee No. 53-03, dated May 23, 2003. 2 2. Application of FIRPTA to RICs The Act modifies the application of FIRPTA to 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 generally are required to withhold tax on FIRPTA gains at a 35 percent rate. We are pleased to inform you that the Act adopts the Institute's proposal to narrow FIRPTA's application to RICs and RIC shareholders. As a result of this change, the vast majority of RICs will not need to incur the burden of determining whether they hold stock in one or more corporations treated as U.S. real property holding companies. Under section 504 of the Act, a RIC will be a qualified investment entity (which is a trigger for FIRPTA application) only if, in general, more than half of its assets are invested directly or indirectly in REITs or U.S. real property holding companies. This change will be effective as if it were included in the American Jobs Creation Act of 2004. Under section 505 of the Act, distributions by a RIC that is a qualified investment entity, with respect to its publicly traded stock, are not treated as FIRPTA gain (even if the distribution is attributable to the sale or

exchange of a U.S. real property interest) unless the foreign shareholder owns 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 is treated as ordinary income. The Act extends FIRPTA in certain respects. Section 505 of the Act ensures that FIRPTA applies to a distribution by a qualified investment entity to the extent that the distribution is attributable to FIRPTA gain included in a capital gain dividend received from an investment by the qualified investment entity in a “lower-tier” qualified investment entity. This change applies to taxable years of qualified investment entities beginning after December 31, 2005. Section 505 of the Act amends the Internal Revenue Code’s (the “Code’s”) foreign withholding provisions to statutorily require a qualified investment entity to withhold tax on FIRPTA gain at a rate of 35 percent, or a lesser rate as provided in Treasury regulations. This change also applies to tax years beginning after December 31, 2005, except that no amount will be required to be withheld with respect to any distribution before the date of enactment of the Act unless such amount was otherwise required to be withheld under the Code as in effect before the amendments made by the Act. Section 506 of the Act treats as FIRPTA gain certain amounts realized by a foreign investor or a qualified investment entity 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 is FIRPTA gain to the extent that the investor would have received a distribution treated as gain subject to FIRPTA had the investor retained the investment in the qualified investment entity. These rules also apply to substitute dividend payments (within the meaning of Code section 861). The portion of a substitute dividend or similar payment treated as FIRPTA gain equals the portion of the distribution such payment is in lieu of that otherwise would have been treated as FIRPTA gain. 3 The Act does not apply wash sale transaction treatment in two situations. First, this treatment does not apply if the investor actually received the distribution. Second, this treatment does not apply if the investor disposed of shares in a qualified investment entity that are 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. The Act does not require withholding with respect to an applicable wash sale transaction. The FIRPTA wash sale rules generally apply to taxable years beginning after December 31, 2005, except that these rules do not apply to any distribution, or substitute dividend payment, occurring before the date that is 30 days after the date of enactment. 3. Reporting of Tax-Exempt Interest Section 502 of the Act amends the information reporting rules so that interest paid on tax-exempt bonds is subject to information reporting in the same manner as interest paid on taxable bonds. The provision applies to tax-exempt interest earned after December 31, 2005. 4. Elimination of Income Limitations on Roth-IRA Conversions Under current law, an individual may not convert a traditional IRA to a Roth IRA unless, in the year of the conversion, the individual’s (a) filing status is other than married filing separately and (b) modified adjusted gross income is less than or equal to $100,000. Effective for taxable years beginning after December 31, 2009, the Act eliminates these two requirements by deleting Code section 408A(c)(3)(B). As under current law, when an individual converts a traditional IRA to a Roth IRA, the individual generally must include the amount converted in gross income in the year of the conversion. The Act provides that for conversions in the 2010 tax year (and only in 2010), the amount required to be included in gross income will be included ratably over the 2011 and 2012 tax years, unless the individual elects to include the entire amount in 2010.4 The Act does not eliminate the income limits for contributions to Roth IRAs, which phase in at $150,000 for joint returns and $95,000 for most others. These limits will likely be of much less consequence beginning in 2010 because an individual could make deductible or nondeductible traditional IRA contributions and then immediately convert those contributions to Roth contributions, regardless of income or filing status. 4 The Act includes a special rule that accelerates the amount required to be taken into income in 2011 if an individual makes a conversion in 2010, elects the two-year inclusion rule, and subsequently takes a distribution of the converted Roth IRA in 2010 or 2011. In that case, the amount required to be taken into gross income in 2010 or 2011 is increased by the amount of the distribution from the converted Roth IRA. For example, if an individual converts $10,000 from a traditional IRA to a Roth IRA in 2010, elects the two-year inclusion rule, and then receives a distribution of $2,000 in 2011, the amount required to be included in gross income in 2011 and 2012 will be $7,000 and $3,000, respectively. 4 5. New Loan and Redemption Requirements on Pooled Financing Bonds Section 508 of the Act imposes 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 30 percent of the net proceeds; (ii) the issuer's reasonable expectation that at least 30 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 applies to bonds issued after the date of enactment. Lisa Robinson Michael L. Hadley Associate Counsel – Tax Law Assistant Counsel – Pension Regulation

---