MEMO# 17708

June 25, 2004

HOUSE PASSES ETI LEGISLATION WITH EXTENSIVE TAX PROVISIONS

[17708] June 25, 2004 TO: TAX MEMBERS No. 33-04 ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 7-04 RE: HOUSE PASSES ETI LEGISLATION WITH EXTENSIVE TAX PROVISIONS The House of Representatives has passed H.R. 4520, the American Jobs Creation Act of 2004.1 This legislation is intended to comply with the ruling of the World Trade Organization ("WTO") that the extraterritorial income ("ETI") regime is inconsistent with our obligations under the General Agreement on Tariffs and Trade. In addition to the provisions that would make changes to certain aspects of the U.S. international tax rules, H.R. 4520 includes a number of other tax provisions that may be of interest to Institute members. The Senate has already passed a bill intended to comply with the WTO ruling,2 and the two chambers expect to try to reach agreement on a compromise bill later this year. 1. Flow-Through of Interest and Short-Term Gains to Foreign Investors Section 286 of the bill would amend section 871 and section 1441 of the Code (and make certain related amendments) to treat distributions of short-term capital gains and U.S.-source interest income by U.S. funds to foreign investors as exempt from U.S. withholding tax. Currently, foreign investors are subject to withholding tax on all ordinary dividends from RICs, although they are exempt from withholding tax on interest and short-term capital gains if they invest directly in U.S. securities. This provision would allow RICs to designate a portion of ordinary dividends as "interest-related dividends" (which could not exceed accrued U.S.-source interest, less expenses allocable to such interest) or as "short-term capital gain dividends" (which could not exceed the excess of net short-term capital gain over net long-term capital loss, after applying a post-October loss push rule), and those dividends would generally be exempt from tax when paid to a foreign investor. 1 The full text of H.R. 4520 as passed by the House can be found through the Library of Congress' online legislative service at http://thomas.loc.gov. 2 See Institute Memorandum to Tax Members No. 29-04 and to Adviser Distributor Tax Issues Task Force No. 6-04 [17628], dated June 4, 2004. 2 Section 286 would also extend the provisions of section 897 of the Code (the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA) that currently apply to REITs to RICs. As a result, RIC distributions attributable to gain from dispositions of "U.S. real property interests" (as defined in the Code and regulations) would be subject to withholding when paid to a foreign investor. This provision would take effect for taxable years of RICs beginning on or after January 1, 2005. The provision is similar to language in H.R. 2896, which was approved by the House Ways and Means Committee last October.3 2. Election to Use Spot Exchange Rate for Foreign Taxes Paid Section 308 of the bill would amend section 986(a) of the Internal Revenue Code (the "Code") to permit taxpayers to elect not to use the average exchange rate for the year in translating foreign taxes paid into dollars to determine the foreign tax credit available. Under the provision, RICs could use the spot exchange rate at the time the tax was paid for purposes of calculating foreign tax credits.

The election to use spot rates would apply for all taxable years, and could not be revoked except with permission of the Treasury. The effective date of this provision would be tax years beginning on or after January 1, 2005. The Senate bill contains a similar provision (section 224). 3. Distributions From Publicly-Traded Partnerships Section 284 of the bill would amend section 851(b)(2) of the Code to provide that distributions or other income derived from a “qualified publicly-traded partnership” (“QPTP”) constitute “good income” for Subchapter M RIC qualification test purposes without looking- through the partnership to determine the income’s source. The provision also would amend the asset test of section 851(b)(3) to include equities issued by a QPTP within the term “outstanding voting securities,” and to limit a RIC to investing no more than 25 percent of its total assets in the securities of one or more QPTPs. A QPTP would be defined as a publicly-traded partnership under section 7704(b), but would not include a partnership if 90 percent or more of its gross income would be “good income” within the meaning of current section 851(b)(2). The provision also would make RICs subject to the passive activity loss rules of section 469 separately with respect to losses attributable to each investment in a publicly-traded partnership. The provision would take effect for taxable years beginning after the date of enactment. This provision also appears in the Senate bill (section 899). 4. Expansion of Deduction for Deficiency Dividends Section 285(f)(5) of the bill would amend section 860(e) of the Code to permit RICs to take a deduction for a deficiency dividend where the taxpayer determines that an adjustment of tax liability is appropriate, and files a statement attached to an amended or supplemented tax 3 See Institute Memorandum to Tax Members No. 59-03 [16708], dated October 29, 2003. 3 return. Currently, a deduction for a deficiency dividend is allowed after a determination of tax liability is made by a court or in a closing agreement. This provision would be effective for tax years beginning after the date of enactment. 5. Straddles Section 687 of the bill would make several changes to the rules governing straddles. First, this provision would enact new rules for identified straddles. Under the bill, a taxpayer who identifies a straddle at the time the straddle is created, and realizes a loss on one leg of the straddle, would increase its basis in the remaining leg of the identified straddle by the amount of the loss, rather than deferring the loss to the extent of unrealized gain. Example. A taxpayer owns 100 shares of C Corp. with a basis of $75 per share and a fair market value of $100 per share, and purchases a put with a strike price of $90 on 100 shares for $500. The put expires unexercised. If the taxpayer had identified the straddle at the time the put was purchased, then the taxpayer would increase its basis in the shares to $80 a share ($500 loss spread over 100 shares). Second, the bill would repeal the stock exception (section 1092(d)(3)) to the straddle rules, and would also repeal Treasury’s authority to apply the qualified covered call exception (section 1092(c)(4)) to over-the-counter options. In addition, the bill would amend section 246(c) to suspend holding periods for stock when a taxpayer writes an “in the money” qualified covered call (i.e., with a strike price below the stock price) on substantially identical stock or securities. Finally, the bill would enact a new rule for certain physically-settled positions. If a taxpayer would incur a loss by terminating a position in a straddle, and instead settles the position by delivering property, the taxpayer would be treated as having engaged in two transactions: 1) terminating the straddle position at fair market value, and 2) selling at fair market value the property used to settle the position. These amendments would take effect for positions established on or after the date of enactment of the legislation. The Senate bill contains a similar provision (section 464). 6. Minimum Holding Period for Foreign Tax Credits on Income Other Than Dividends Section 632 of the bill would amend section 901 of the Code to establish a new holding period requirement to be eligible for foreign tax credits attributable to withholding tax on income other than dividends. Under the provision, in order to be entitled to a tax credit for a foreign withholding tax, a taxpayer would be required to hold the relevant property for more than 15 days during the 30 day period that begins 15 days before the date on which the right to receive the payment arises. In addition, a taxpayer would not be entitled to a foreign tax credit to the extent that it is obligated to make related payments with respect to positions in substantially similar or related property, and certain rules similar to the existing rules under section 901(k) would apply. 4 The provision would be effective for amounts paid or accrued more than 30 days after enactment of the legislation. The Senate bill contains a similar provision (section 456). 7. Tax Shelters There are several provisions in the bill relating to abusive tax shelters. Section 611 of the bill would impose a penalty of $50,000 for failing to disclose a reportable transaction ($10,000 in the case of a natural person) and $200,000 for failure to disclose a listed transaction ($100,000 in the case of a natural person).4 The Commissioner would have the authority to rescind these penalties under certain circumstances, and must keep a record of any rescissions granted. The Senate bill contains a similar provision (section 402). If a taxpayer has a reportable transaction understatement for any taxable year, section 612 of the bill would impose an additional tax equal to 20 percent of the amount of the understatement. This additional tax generally applies to any listed transaction and any reportable transaction if a significant purpose of the transaction is the avoidance or evasion of Federal income tax. A higher additional tax of 30 percent of the understatement is imposed if the taxpayer fails to disclose the listed or reportable transaction. The bill also addresses special rules for (1) coordination of this substantial understatement penalty with other penalties, including penalties on other understatements, (2) amended returns and (3) administrative review. This substantial understatement penalty would not be imposed if the taxpayer shows that there was reasonable cause (as described in the bill and subject to certain qualifications) for the understatement and the taxpayer acted in good faith. The Senate bill contains a similar provision (section 403). Section 613 of the bill would provide for a tax shelter exception to confidentiality privileges relating to taxpayer communications. The privilege would not apply to communications involving a federally authorized tax practitioner in connection with the promotion of direct or indirect participation in a tax shelter. The Senate bill contains a similar provision (section 406). The bill includes a number of provisions that would be applicable to material advisors,5 which would not affect RICs, but might affect management companies in some circumstances. Section 615 would require material advisors to file a return setting forth (1) information identifying and describing the reportable transaction, (2) information describing any potential tax benefits expected to result from the transaction and (3) any other information required by 4 As suggested by the Institute, RICs are excluded from every reportable transaction category except for listed transactions. See Institute Memorandum to 529 Plan Advisory Committee No. 14-03, Accounting/Treasurers Members No. 13-03, Advisor Distributor Tax Issues Task Force No. 5-03, Tax Members No. 15-03 and Unit Investment Trust Members No. 9-03 (No. 15707), dated March 7, 2003. 5 A material advisor means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction and who directly or indirectly derives gross income in excess of the threshold amount for such aid, assistance, or advice. The threshold amount is equal to $50,000 in the case of a reportable transaction where substantially all of the tax benefits are provided to a natural person, and $250,000 in all other cases. 5 the Secretary. Material advisors also would keep lists of their advisees and furnish these lists to the Secretary upon request. The Senate bill contains a similar provision (section 407). Section 616 of the bill would modify the penalty provisions applicable to tax shelters. If a material advisor fails to file a return or files a false return with respect to a reportable transaction, a penalty of $50,000 for any failure is imposed. The penalty imposed on material advisors for failure to file a return or for filing a false return with respect to any listed transaction would be the greater of $200,000 or 50 percent (75 percent in the case of an intentional failure or act) of the gross income derived by such person with respect to aid, assistance, or advice provided with respect to the listed transaction before the date the return including the transaction is filed. The Commissioner would have the authority to rescind this penalty under rules similar to the penalty rescission rules applicable to failures to disclose reportable transactions. The Senate bill contains a similar provision (section 408). Section 617 of the bill provides that, if a material advisor fails to provide the Secretary with a list of advisees within 20 business days after the date of the Secretary's written request, such person would be subject to a penalty of $10,000 for each day of such failure. No penalty would be imposed if there were a reasonable cause for the failure to provide the list. The Senate bill contains a similar provision (section 409). The bill's tax shelter provisions generally would be applicable to transactions in taxable years beginning after the date of enactment. 8. Miscellaneous Provisions In addition to the provisions highlighted above, there are several other provisions that may be of interest to members. These provisions include: Section 313 would repeal sections 551 through 558, relating to foreign personal holding companies, and sections 1246 and 1247, relating to foreign investment companies, and make certain related and conforming amendments; the Senate bill contains a similar provision (section 221); Section 631 would grant Treasury authority to promulgate regulations to apply the rules of Code sections 1286 and 305(e) (relating to stripped bonds and preferred stock) to accounts or entities substantially all of the assets of which are bonds, preferred stock, or both; the Senate bill contains a similar provision (section 461); and Section 635 would repeal sections 860H through 860L of the Code, relating to financial asset securitization trusts ("FASITs"), and make certain additional conforming amendments; the Senate bill contains a similar provision (section 433). David Orlin Lisa Robinson Assistant Counsel Assistant Counsel

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