MEMO# 17184

March 22, 2004

HIGHWAY TRUST FUND BILL INCLUDES SEVERAL TAX PROVISIONS

[17184] March 23, 2004 TO: 529 PLAN ADVISORY COMMITTEE No. 11-04 ACCOUNTING/TREASURERS MEMBERS No. 15-04 ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 4-04 TAX MEMBERS No. 17-04 UNIT INVESTMENT TRUST MEMBERS No. 11-04 RE: HIGHWAY TRUST FUND BILL INCLUDES SEVERAL TAX PROVISIONS The Senate has passed legislation – including provisions relating to straddles and tax shelters – that may be of interest to regulated investment companies ("RICs") and their shareholders.1 1. Straddles Among the tax provisions are several changes to the rules governing straddles. First, the bill would enact new rules for identified straddles. Under Section 5678 of 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, will increase its basis in the remaining leg of the identified straddle by the amount of the loss. 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 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). Unlike the "last dollar" rule in current law, this provision would allow a taxpayer to realize a pro rata portion of the loss on the put as the taxpayer realizes gain from the appreciated position (i.e., each share sold at $100 would produce $20, not $25, of gain). Also unlike current law, it should be noted that the provision would apply to identified straddles 1 The bill (S. 1072) is titled the Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2004, otherwise known as "SAFETEA" or the Highway Trust Fund Bill (hereinafter "the bill"). Statutory language can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:s1072es.txt.pdf. The straddle provisions are contained in Section 5678 of the bill, which can be found at pages 1371-1375. The tax shelter provisions discussed in this memorandum are contained in Title V, subtitle G, part II ("Provisions Designed to Discourage Tax Shelters"), which includes Sections 5611 through 5678 and can be found at pages 1239-1289 of the bill. 2 even when there is no unrecognized gain in the remaining position. As a result, identifying a straddle could result in deferring realization of losses that would not be deferred under current law, or on unidentified straddles.2 Second, the bill would repeal the qualified covered call exception (Section 1092(c)(4)) and the stock exception (Section 1092(d)(3)) to the straddle rules. The repeal of the qualified covered call exception would force taxpayers who write covered calls to determine whether a straddle has been created, and to defer losses from calls subject to the straddle rules. 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. 2. Tax Shelter Penalties There are several provisions in the bill relating to abusive tax shelters. The bill imposes a penalty of $50,000 for failing to disclose a reportable transaction and $100,000 for failure to disclose a listed transaction3. These penalties are doubled for large entities and high net worth individuals.4 The Commissioner has the authority to rescind these penalties under certain circumstances, and must keep a record of any rescissions granted. If a taxpayer has a reportable transaction understatement for any taxable year, the bill imposes an additional tax equal to 20% 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% of the understatement is imposed if the taxpayer fails to disclose the listed or other avoidance 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 will not be imposed if the taxpayer shows that there was reasonable cause (as explained in the bill and subject to certain qualifications) for the understatement and the taxpayer acted in good faith. 2 The legislation authorizes Treasury to issue regulations preventing taxpayers from identifying straddles where there is no unrealized gain in either position. 3 See bill Sec. 5612. As suggested by the Institute, regulated investment companies (“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. 4 A “large entity” means, with respect to any taxable year, a person (other than a natural person), with gross receipts in excess of $10,000,000 for the taxable year in which the reportable transaction occurs or the preceding taxable year. “High net worth individual” means, with respect to a reportable transaction, a natural person whose net worth exceeds $2,000,000 immediately before the transaction.” 3 If a taxpayer has a noneconomic substance transaction understatement (as defined in the bill) for any taxable year, the bill imposes a penalty equal to the amount of 40% of the amount of the understatement.5 This penalty is reduced to 20% in situations where the taxpayer has adequately disclosed relevant facts affecting the tax treatment of the item on a tax return. a. Material Advisors The bill includes a number of provisions that would be applicable to material advisors6, which would not affect RICs, but might affect management companies in some circumstances. The bill requires 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 the Secretary. Material advisors also must keep lists of their advisees and furnish these lists to the Secretary upon request. 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 is the greater of $200,000 or 50% (75% 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 has the authority to rescind this penalty under rules similar to the penalty rescission rules applicable to failures to disclose reportable transactions. 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 will be subject to a penalty of $10,000 for each day of such failure. No penalty will be imposed is there is a reasonable cause for the failure to provide the list.7 A taxpayer that is required to file periodic reports under section 13 or 15(d) of the Securities Exchange Act must report under these rules any penalty imposed for (1) failing to disclose a reportable transaction, (2) a substantial understatement of tax attributable to a reportable transaction or (3) a substantial understatement of tax attributable to a transaction that lacks economic substance. A failure to report the imposition of any of these penalties to the SEC could subject the taxpayer to additional penalties for failing to disclose a reportable transaction. 5 As defined in Sec. 5611 of the bill, a transaction has economic substance if “(I) the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer’s economic position, and (II) the taxpayer has a substantial nontax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.” The bill’s definition includes special rules for situations where the taxpayer relies on economic substance by reason of having profit potential and transactions involving tax-indifferent parties, i.e., entities not subject to Federal income tax. 6 Bill Sec. 5617. 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. 7 Bill Sec. 5621. 4 b. Effective Date The bill’s tax shelter provisions generally are applicable to transactions in taxable years beginning after the date of enactment. David Orlin Lisa Robinson Assistant Counsel Assistant Counsel