MEMO# 17628

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SENATE PASSES ETI LEGISLATION WITH EXTENSIVE TAX PROVISIONS

[17628] June 4, 2004 TO: TAX MEMBERS No. 29-04 ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 6-04 RE: SENATE PASSES ETI LEGISLATION WITH EXTENSIVE TAX PROVISIONS The Senate has passed S.1637, the “Jumpstart Our Business Strength (“JOBS”) Act.”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 making changes to certain aspects of the US international tax rules, S.1637 includes a number of other tax provisions that may be of interest to Institute members.2 Legislation to comply with the WTO ruling (H.R. 4520, “the American Jobs Creation Act”) was introduced in the House of Representatives today and may be considered by the House Ways and Means Committee and the full House this month. 1. Election to Use Spot Exchange Rate for Foreign Taxes Paid Section 224 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, regulated investment companies (“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. 1 The full text of S.1637 as passed by the Senate can be found through the Library of Congress’ online legislative service at http://thomas.loc.gov. 2 Several of these provisions were passed by the Senate earlier this year in unrelated legislation. See Institute Memorandum to Tax Members No. 17-04, and to Adviser Distributor Tax Issues Task Force No. 4-04 [17184], dated March 23, 2004. 2 2. Denial of Deduction for Certain Penalties Section 423 of the bill would amend section 162(f) of the Code regarding the deductibility of fines, penalties and other amounts. Currently section 162(f) denies a tax deduction only for a “fine or similar penalty paid to a government.” Section 423 would expand this provision to deny a deduction for “any amount paid . . . to, or at the direction of, a government or [certain self-regulatory organizations] in relation to the violation of any law or the investigation or inquiry . . . into the potential violation of any law.” However, the provision expressly provides for the deductibility of 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). The provision also does not deny deductibility for payments made pursuant to a court order where no government or relevant SRO is a party to the action. The provision would be effective for payments made after April 27, 2003, except it would not apply to any payments made pursuant to a binding order or agreement

entered into before April 27, 2003.3 3. Distributions From Publicly-Traded Partnerships Section 899 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. 4. Straddles Section 464 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. 3 An agreement subject to court approval is not considered binding for these purposes unless court approval was obtained on or before April 27, 2003. 3 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. 5. Holding Period for QDI on Preferred Stock Section 496 of the bill would extend the holding period requirement for shareholders to treat dividend income on preferred stock as qualified dividend income ("QDI") from 90 days out of the 180-day period surrounding the ex-dividend date to 120 days out the 240-day period surrounding the ex-dividend date.4 This provision would be effective for taxable years beginning after enactment of the legislation. 6. Minimum Holding Period for Foreign Tax Credits on Income Other Than Dividends Section 456 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. 4 The provision does not reflect the provision of the pending technical correction legislation that would change the interval over which holding periods are tested to 121 days for common stock and 181 (or 241) days for preferred stock. 4 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. The provision would be effective for amounts paid or accrued more than 30 days after enactment of the legislation. 7. CEO Declaration Regarding Corporate Tax Return Accuracy Section 422 of the bill would require every tax return filed by a corporation to include a declaration by the chief executive officer (CEO) under penalties of perjury that the corporation has policies and procedures to ensure the accuracy of the return, and the CEO has received reasonable assurances as to the accuracy of all material aspects of the return. This provision would not apply to RICs. This provision would be effective for returns filed with respect to income for tax years ending after the date of enactment of the legislation. 8. Tax Shelters There are several provisions in the bill relating to abusive tax shelters. Section 402 of the bill would impose a penalty of $50,000 for failing to disclose a reportable transaction and $100,000 for failure to disclose a listed transaction.5 These penalties would be doubled for large entities and high net worth individuals.6 The Commissioner would have the authority to rescind these penalties under certain circumstances, and must keep a record of any rescissions granted. A taxpayer that is required to file periodic reports under section 13 or 15(d) of the Securities Exchange Act of 1934 would 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. If a taxpayer has a reportable transaction understatement for any taxable year, section 403 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 5 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. 6 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.” 5 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. Under section 404 of the bill, if a taxpayer has a non-economic substance transaction understatement (as defined in the bill) for any taxable year, the taxpayer would be subject to a penalty equal to 40 percent of the amount of the understatement.7 This penalty would be reduced to 20% in situations where the taxpayer has adequately disclosed relevant facts affecting the tax treatment of the item on a tax return. Section 406 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 bill includes a number of provisions that would be applicable to material advisors,8 which would not affect RICs, but might affect management companies in some circumstances. Section 407 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 the Secretary. Material advisors also would keep lists of their advisees and furnish these lists to the Secretary upon request. Section 408 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. 7 As defined in sec. 401 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 non-tax 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. 8 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. 6 Section 409 of the bill would provide 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 will be subject to a penalty of $10,000 for each day of such failure. No penalty would be imposed if there is a reasonable cause for the failure to provide the list. The bill's tax shelter provisions generally would be applicable to transactions in taxable years beginning after the date of enactment. 9. Miscellaneous Provisions In addition to the provisions highlighted above, there are a number of other provisions that may be of interest to members. These provisions include: Section 221 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; Section 225 would amend section 904(d)(2) of the Code to allow taxpayers to elect to treat tax imposed on amounts that do not constitute income for US tax purposes as tax imposed on income; Section 308 would amend section 541 of the Code to suspend the personal holding company tax for any year in which current section 1(h)(11) is in effect; Section 433 would repeal sections 860H through 860L of the Code, relating to financial asset securitization trusts ("FASITs"), and make certain additional conforming amendments; Section 441 would establish new rules (section 7874 of the Code) for treating certain foreign corporations as inverted domestic corporations; as requested by the Institute, a special transition rule for RICs would apply to acquisitions completed between March 20, 2002 and January 1, 2004; Section 461 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; Section 474 would amend section 195(b), section 248(a), and section 709(b) (which relate to start-up expenditures of an active trade or business, organizational expenditures of a corporation, and organizational expenditures of a partnership, respectively), to provide that no more than $5,000 of start-up or organizational expenditures can be deducted in the first year of a new business,9 with the remaining organizational expenditures deducted ratably over fifteen years, rather than five years; Section 661 would amend section 1(h)(5) of the Code to tax bullion at regular capital gain rates, rather than as collectibles; and 9 The amount that can be deducted in the first year is the lesser of actual expenses or $5,000, reduced (but not below zero) by expenditures in excess of $50,000. 7 Section 733 would amend Section 1275(d) of the Code to require the regulations dealing with contingent payment debt instruments to provide that the comparable yield on a contingent convertible debt instrument is determined by reference to a noncontingent convertible debt instrument, rather than a noncontingent debt instrument that is not convertible. 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