MEMO# 15579

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TREASURY EXPLANATION OF EXCLUDABLE DIVIDEND PROPOSAL

[15579] January 23, 2003 TO: TRANSFER AGENT ADVISORY COMMITTEE No. 8-03 RE: TREASURY EXPLANATION OF EXCLUDABLE DIVIDEND PROPOSAL The Treasury Department has released the attached detailed explanation of the President's dividend exclusion proposal. This explanation differs in some respects from earlier Treasury descriptions of the proposal. Set forth below is a general overview of several provisions of particular interest to regulated investment companies ("RICs") and their shareholders. Excludable Dividends Under the proposal, certain distributions made by a corporation to its shareholders would be excluded from the shareholders' taxable income ("excludable dividends"). If a corporation distributed as dividend income more than the excludable amount, a proportionate amount of each dividend would be treated as excludable. A RIC generally would be permitted to flow through to its taxable shareholders the excludable dividends it receives on equities held in its portfolio. Excludable Dividend Amount ("EDA") The amount that a corporation could pay as an excludable dividend generally would be limited to the corporation's excludable dividend amount ("EDA"). A corporation's EDA essentially reflects corporate income that has been fully taxed in the US (including US income taxes, on foreign source income, that would have been paid but for offsetting foreign tax credits). For example, if a corporation has $100 of taxable income on which it pays $35 of US income tax, the EDA will be $65.1 EDA would be increased or decreased by various adjustments discussed in detail in the Treasury explanation. A corporation's EDA for a calendar year would be based on the tax shown on the tax return filed in the preceding calendar year. Thus, for example, if a corporation with a fiscal year 1 The formula for determining EDA is: (US corporate income tax divided by .35) minus US corporate income tax. In the example above, the corporation's $35 of tax divided by .35 equals $100; this $100 less tax paid of $35 equals $65. If a corporation instead had taxable income of $100, but paid only $20 of US tax (because of, for example, R&D tax credits), the EDA would be $37.14, calculated as follows: $20/.35 (or $57.14) minus $20. 2 ending on December 31, 2001 filed its tax return on September 15, 2002 (the due date plus extensions), the tax shown on that return would determine its EDA for calendar year 2003. Retained Earnings Basis Adjustments ("REBAs") A corporation that did not distribute as excludable dividends the full amount of its EDA for a calendar year could provide its common shareholders with increases in the cost basis of their shares equal to the undistributed amount. A RIC would be permitted to flow through these retained earnings basis adjustments ("REBAs") as basis adjustments to its shareholders. REBAs could be made by the corporation at any point during the calendar year. For example, if a corporation's EDA for the calendar year were $65 and the corporation distributed only $50 of excludable dividends (thereby reducing its EDA to $15), the remaining $15 of EDA could be treated as a REBA and increase proportionately the cost basis of the common shareholders' shares. Cumulative Retained Earnings Basis

Adjustments (“CREBAs”) In addition, the cumulative amount of REBAs for all years -- an amount referred to as the cumulative retained earnings basis adjustment (“CREBA”) -- could be used by a corporation to pay excludable dividends in a year for which the EDA is insufficient to ensure excludable dividend treatment for the full amount of the distributions.2 A RIC would be permitted to flow through a distribution out of CREBA to its shareholders. Distributions out of CREBA would reduce each shareholder’s cost basis in his or her shares. Any distributions out of CREBA in excess of any shareholder’s cost basis would be treated as capital gain. Ordering Rule for Distributions The Treasury explanation provides the following ordering rules where a corporation’s distributions for a calendar year exceed its EDA (and only a proportionate amount of each distribution, as noted above, is treated as an excludable dividend). Specifically, a distribution in excess of EDA is treated as (1) a return of basis, and then capital gain, to the extent of CREBA (as noted above); (2) a taxable dividend to the extent of the corporation’s earnings and profits; (3) a return of capital to the extent of a shareholder’s remaining basis; and (4) capital gain. 2 For example, assume a corporation that has a $15 REBA in Year One and a $10 REBA in Year Two; if the corporation has no EDA in Year Three, it nevertheless could pay excludable dividends of $25 out of CREBA. A $25 distribution in this example would reduce the corporation’s CREBA to zero. 3 RIC Distribution Requirements A RIC would not be allowed a dividends paid deduction for distributions that are excludable or from CREBA. For purposes of the RIC distribution requirements, excludable dividends would be treated in the same manner as tax-exempt interest (i.e., subject to a 90 percent distribution requirement). Shareholder-Level Requirements Shareholders generally would exclude their excludable dividends from gross income. IRS Forms 1099 would be modified to provide the amount of any excludable dividend, any REBA and any CREBA. A shareholder would not be eligible for excludable dividend or REBA treatment unless the stock were held for more than 45 days during the 90-day period beginning 45 days before the ex-dividend date (with a more-than-90-day holding period requirement applicable to preferred stock). The rules of section 1059 -- which require a basis reduction for certain dividends eligible for the dividends received deduction3 -- would be extended to apply with respect to excludable dividends. Rules similar to the rules under section 854(b)(2) -- which disallow losses on RIC shares held for 6 months or less to the extent of exempt-interest dividends received during the holding period -- would apply to a RIC shareholder receiving an excludable dividend or a REBA. Foreign Shareholders US withholding tax would continue to apply to dividends paid to nonresident alien (foreign) investors -- whether those dividends were excludable or not -- and to distributions from CREBA. US withholding tax would not apply, however, to REBAs (as foreign investors are not subject to withholding tax on capital gains). Treatment of Pension Plans, 401(k) Plans and Individual Retirement Accounts The proposal would not change the tax treatment of retirement plans. The Treasury document provides an explanation of why investment income from retirement plans already is effectively free from tax and why, consequently, investments in retirement plans would remain tax advantaged relative to investments in taxable accounts. Other Rules Certain types of redemptions would reduce EDA. The proposal also would repeal the personal holding company rules. 3 The proposal also would repeal the corporate dividends received deduction for portfolio investments, subject to transition rules. 4 Effective Date The proposal would apply to dividends (and REBAs) received beginning in 2003. Keith Lawson Senior Counsel Attachments Attachment no. 1 (in .pdf format)
