CLIENT ALERT

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New Tax Law Extends Preferential Rates on Dividends and Capital Gains

Earlier today, the President signed the Tax Increase Prevention and Reconciliation Act of 2005, a $69 billion package of tax cuts. The Act extends preferential rates on dividends and capital gains, with the result that nearly all of President Bush's tax cuts, including rate reductions for individuals, increased child tax credit, and the elimination of estate taxes, will expire simultaneously at the end of 2010.

Highlights of the Act include:

Two year extension of the 15% maximum rate on qualified stock dividends and capital gains through 2010.

Alternative minimum tax relief is provided by extending the allowance of certain nonrefundable personal credits against minimum tax liabilities and increasing the minimum tax exemption for 2006 from $58,000 to $62,550 for married filing joint taxpayers and from $40,250 to $42,500 for single taxpayers. The changes are effective for 2006.

Two year extension of certain exceptions to "Subpart F" income through tax years beginning in 2008 for income derived in the active conduct of a banking, financing or similar business, or in the conduct of an insurance business.

Modification of the definition of "Subpart F" income to exclude dividends, interest, rents, and royalties received by one controlled foreign corporation ("CFC") from a related CFC to the extent that the payment is not attributable to Subpart F income of the related CFC, applicable to tax years of foreign corporations beginning after December 31, 2005, but before January 1, 2009.

Extension of increased expensing under Section 179 for small businesses through 2010. This provision allows a deduction of up to $100,000, in lieu of depreciation, for companies that put less than $400,000 of qualifying property into service in a given year.

Application of capital gain treatment to musical compositions or copyrights in musical works created by a taxpayer's personal efforts. The Act does <u>not</u>, however, permit a full fair market value deduction for charitable contributions of such works. This provision applies to taxable years beginning after the date of enactment, but only to sales or exchanges before January 1, 2011. The bill also allows amortization of expenses incurred in creating or acquiring music or music copyrights by certain individual and closely held business over five years, and applies to any taxable year beginning after December 31, 2005 and before January 1, 2011.

Certain settlement funds relating to environmental cleanup are now treated as beneficially owned by the United States government and therefore not subject to tax. This provision applies to accounts and funds established after the date of enactment through December 31, 2010.

Increase of the capital expenditure limit for qualified small-issue bonds under section 144 of the Code, from $10 million to $20 million. Under prior law, this change was to take affect for bonds issued after September 30, 2009, but will now be effective for bonds issued after December 31, 2006.

Revenue Raisers

In order to help fund the cost of the bill, several offsetting provisions were enacted, including:

Imposition of an excise tax on tax-exempt entities entering into prohibited tax shelter transactions. Under the new provisions, tax-exempt entities that are a party to and approve of prohibited tax shelter transactions must pay tax on income from the transaction at the highest corporate rate, or an excise tax equal to the highest corporate tax rate times the greater of the income from the transaction or seventy-five percent of the proceeds from the transaction. This change is applicable to taxable years ending after the date of enactment.

Temporarily removing the income limits on conversions of traditional IRAs to Roth IRAs. The provision would raise about $7 billion between 2011 and 2015 as high income taxpayers convert from traditional to Roth IRAs and pay taxes on the amount being converted. (Opponents argued that the long-term effect will be significant revenue losses after 2015 as holders of converted Roth IRAs make withdrawals on a tax-free basis.) This change is effective for tax years beginning after December 31, 2009.

Application of "earnings stripping" rules under section 163(j) of the Code to corporations that are partners, to include such corporations' allocable share of interest paid or accrued on liabilities of partnerships. Under prior law, section 163(j) arguably only applied to interest paid or accrued by the corporation itself. The change is effective for taxable years beginning on or after the date of enactment.

Narrowing the application of the Foreign Investment in Real Property Tax Act ("FIRPTA") rules to Regulated Investment Companies ("RICs"), while imposing withholding requirements on those RICs to which FIRPTA does apply, as well as slightly expanding the previous withholding obligations of Real Estate Investment Trusts ("REITs"). These changes are generally effective for distributions from RICs on or after the date of enactment.

The maximum age for minor children whose unearned income is taxed at their parents' rate has been increased from 13 to 17, effective for 2006.

New requirements for pooled financing bonds to be eligible for tax exemption, including (i) written loan commitments as to at least 30% of net proceeds in certain cases, (ii) a reasonable expectation that at least 30% of net proceeds will be lent to borrowers within one year, and (iii) redemption of outstanding bonds with proceeds that are not loaned within applicable loan origination periods. The changes apply to bonds issued after the date of enactment.

The Act repeals "binding contract" transitional relief previously enacted as part of the repeal of the foreign sales corporation ("FSC") regime, that applied to income from contracts that have been continuously effective since September 30, 2000. The general two-year extraterritorial income ("ETI") exclusion phase-out is not affected. The current repeal follows a World Trade Organization holding in early 2006 that the transitional relief was a prohibited export subsidy. The change applies to tax years beginning after the date of enactment.

A number of debated tax provisions were left out of the final bill, but may be picked up in future legislation. These include: extension of the research credit through 2006, extension of the above-the-line deductions for qualified higher education expenses and educator expenses, and additional charitable giving incentives and charitable organization reform provisions.

Contact Information

If you have any questions about the Act, please contact the undersigned or another member of the Tax & Benefits Department.

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