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The American Jobs Creation Act of 2004 – Provisions Affecting Regulated Investment Companies (“RICs”)

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (the “Act”). Originally proposed nearly two years ago to repeal the extraterritorial income exclusion deemed an illegal subsidy by the World Trade Organization, the Act evolved into sweeping legislation that makes extensive changes to the Internal Revenue Code (the “Code”). The Act, among other things, contains certain provisions that significantly affect substantive tax rules applicable to RICs and their shareholders. This memorandum summarizes the provisions affecting RICs in the Act.¹

1. Pass-Through of Portfolio Interest and Short-Term Capital Gains to Foreign Investors

Non-resident alien individuals and foreign corporations (“foreign investors”) are subject to a 30 percent (or lower treaty rate) U.S. withholding tax on the gross amount of U.S.-source fixed, determinable, annual or periodical income, such as interest, dividends, rents or similar types of income. Foreign investors, however, are generally not subject to U.S. tax on capital gains or on interest that qualifies as “portfolio” interest. A RIC may pass through to its shareholders the character of certain specified income items provided applicable requirements are met. However, under prior law, the character of short-term capital gains and portfolio interest did not pass through. Such income was paid out to shareholders as an ordinary income dividend subject to 30 percent (or lower treaty rate) U.S. withholding tax. The Act amends the Code to permit pass through treatment of interest income and short-term capital gains, a change sought by the mutual fund industry for nearly two decades.

The changes described below should enhance the appeal of domestic RICs to foreign investors who, until this point, have had to invest directly in the U.S. or through offshore corporations to obtain the portfolio interest exemption and avoid taxation on short-term capital gain sourced in the U.S. While some prior legislative proposals have included investment thresholds a RIC would need to meet in order to be able to pass

¹ Certain other provisions of the Act are discussed in separate memoranda which are available on the Sidley Austin Brown & Wood LLP website at www.sidley.com.

through interest income and short-term capital gains to foreign investors,² the provisions in the Act contain no investment threshold requirements which need to be satisfied.

A. Exemption of Certain Interest Income from U.S. Taxation for Foreign Investors

Foreign investors are not subject to the 30 percent U.S. withholding tax on interest paid on certain portfolio obligations (“portfolio interest”). Portfolio interest, generally, is defined as any U.S. source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (i) on a registered obligation (or an obligation exempt from registration) which meets specific requirements designed to ensure that the obligation is sold to foreign investors, and (ii) that is not received by a 10 percent shareholder. The exemption of portfolio interest from taxation does not apply to loan interest received by a bank in the ordinary course of its business or by a controlled foreign corporation (“CFC”) from a related person and also does not apply to certain contingent interest payments. Interest payments from certain deposits with banks and other financial institutions are also exempt from tax as is original issue discount on obligations maturing in 183 days or less from the date of original issue.

The Act allows a RIC to pass through to foreign investors as exempt from U.S. taxation certain interest that would not be subject to U.S. tax if earned by a foreign person directly. A foreign person who is a shareholder in the RIC generally will treat such dividend as exempt from the 30 percent U.S. withholding tax, as if such investor had earned the interest directly. To accomplish this, the Act permits a RIC, under certain circumstances, to designate all or a portion of a dividend

as an “interest-related dividend” by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. An interest-related dividend received by a foreign person generally will be exempt from the 30 percent U.S. withholding tax. A RIC may not designate as interest-related dividends more than the RIC’s qualified net interest income, as defined below, for the taxable year, and to the extent a RIC designates a greater amount, only a portion of its distributions will be treated as interest-related dividends.

The qualified net interest income of a RIC equals the excess of: (1) the amount of its qualified interest income (“QII”) over (2) the amount of its expenses properly allocable to such interest income. QII of a RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short-term original issue discount that is currently exempt from 30 percent U.S. withholding; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under applicable Code provisions, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10 percent shareholder or is contingent interest not treated as portfolio interest; and (4) any interest-related dividend from another RIC.

The interest-related dividend tax exemption will not apply to a dividend unless the withholding agent receives a statement, similar to that required under current portfolio interest rules, that the beneficial owners of the shares is not a U.S. person.³ The Act provides that the exemption generally does not apply to dividends paid to a CFC to the extent such dividends are

² For example, a RIC needs to invest at least 50 percent of the value of its assets in obligations paying interest exempt under §103 in order to be able to pay exempt-interest dividends to shareholders. All § references are to the Code.

³ The exemption does not apply to a dividend paid to any person within a foreign country with respect to which the Treasury Secretary has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons.

attributable to income received by the RIC on a debt obligation of a person with respect to which the CFC is a related person.⁴ The exemption also generally does not apply to dividends to the extent such dividends are attributable to income (other than short-term original issue discount or bank deposit interest) received by the RIC on indebtedness issued by the dividend recipient or by any corporation or partnership with respect to which the recipient of the RIC dividend is a 10 percent shareholder.⁵

This provision generally applies to dividends with respect to RIC taxable years beginning after December 31, 2004 and before January 1, 2008.

B. Exemption of Capital Gains from U.S. Taxation for Foreign Investors

Foreign investors generally are not subject to U.S. tax on gain realized on the disposition of stock or securities⁶ (other than certain gains from the sale or exchange of a U.S. real property interest), unless the gain is effectively connected with the conduct of a trade or business in the United States. Gain or loss of a foreign person from the disposition of a U.S. real property interest is subject to net basis tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business. A RIC is not required to withhold on a distribution to a foreign person representing a capital gain dividend, which represents long-term capital gain.

Under the Act, a RIC also may pass through qualifying short-term capital gain to its shareholders, and a foreign person who is a shareholder in the RIC, generally, will treat such a dividend as exempt from the 30 percent U.S. withholding tax as if the investor had realized the gains directly. To accomplish this, a RIC is permitted, under certain circumstances, to designate all or a portion of a dividend as a “short-term capital gain dividend” by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. A short-term capital gain dividend received by a foreign person⁷ generally will be exempt from the 30 percent U.S. withholding tax.

A RIC may not designate as short-term capital gain dividends more than the RIC’s qualified short-term capital gain (defined as the excess of its net short-term capital gain over net long-term capital loss) for the taxable year, and to the extent a RIC designates a greater amount, only a portion of the distribution will be treated as a short-term capital gain dividend. For this purpose, qualified short-term capital gain includes short-term capital gain dividends from another RIC. Qualified short-term capital gain is determined without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the year (unless a special election applies), with such loss treated as arising on the first day of the next taxable year. To the extent provided in regulations, this rule also applies for purposes of computing the taxable income of the RIC. In computing the amount of short-term capital gain dividends for

⁴ The RIC is exempt from any withholding obligation in this circumstance, unless it knows the recipient is a CFC. To the extent that an interest-related dividend received by a CFC is attributable to portfolio interest, the dividend is treated as portfolio interest for purposes of the de minimis rules, the high-tax exception and the same country exceptions of subpart F of the Code.

⁵ The RIC is exempt from any withholding obligation in this circumstance, unless it knows the recipient is a 10 percent shareholder.

⁶ Generally, the exemption does not apply if the foreign person is present in the United States for a period or periods aggregating 183 days or more during the taxable year.

⁷ Generally, the exemption from U.S. taxation for short-term capital gain dividends will not apply if the foreign person is present in the United States for a period or periods aggregating 183 days or more during the taxable year. However, the RIC is exempt from any withholding obligation in this circumstance, unless it knows that the dividend recipient has been present in the United States for such period.

the year, no reduction is made for the amount of expenses of the RIC allocable to such short-term capital gains.

Under the Act, any distribution by a RIC to a foreign person shall, to the extent attributable to gains from sales or exchanges by the RIC of an asset that is considered a U.S. real property interest, be treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. This rule had previously only applied to REITs.⁸

This provision generally applies to dividends with respect to RIC taxable years beginning after December 31, 2004 and before January 1, 2008. With respect to the treatment of U.S. real property interests held by RICs, the provision, likewise, is effective after December 31, 2004 and before January 1, 2008.

C. Exemption from U.S. Estate Taxation for Certain Debt Obligations Paying Interest Exempt from U.S. Taxation

Decedents who are citizens or residents of the United States are generally subject to federal estate tax on all property, wherever situated. Foreign decedents are subject to estate tax only on their property which is within the United States.⁹ Property within the United States generally includes debt obligations of U.S. persons, including the federal government and state and local governments, but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from 30 percent U.S. withholding tax, as described above (“qualifying assets”). Stock owned and held by a foreign decedent is treated as property within the United States only if the stock was issued by a domestic corporation. Under prior law, the estate of a foreign decedent owning stock in a RIC was

treated as owning property within the United States, regardless of whether assets of the RIC would have been treated as situated outside of the United States if held directly.

The Act provides that the estate of a foreign decedent is exempt from U.S. estate tax on RIC stock in the proportion that the assets held by the RIC are qualifying assets. The proportion is measured at the end of the quarter immediately preceding the decedent’s death (or such other time as the Secretary may designate in regulations).

This change applies to estates of decedents dying after December 31, 2004 and before January 1, 2008.

2. Treatment of Publicly Traded Partnerships under RIC Qualification Provisions

A RIC must meet certain income source and asset diversification requirements in order to be able to avoid entity level taxation. In particular, among other things, at least 90 percent of the RIC’s gross income must be derived from certain passive sources, including interest, dividends, gain from the sale of securities (as defined under the Investment Company Act of 1940) and other income related to its business of investing in securities. Income derived from a partnership generally is treated as meeting the income source requirement (i.e., as “good income”) only to the extent such income is attributable to types of income of the partnership that would meet the requirement if realized by the RIC directly (the “look-through” rule). While partnerships generally are not taxable entities, certain publicly traded partnerships (“PTPs”) are treated as corporations, subject to entity level tax, for tax purposes. A PTP is defined generally as a partnership whose interests are (1) traded on an established securities market or (2)

⁸ The Act also extends the special rules for domestically-controlled REITs to domestically-controlled RICs. This has the effect, generally, of exempting the sale of a domestically controlled RIC’s stock from taxation as a U.S. real property interest in the hands of foreign shareholders. Any distribution of a real property interest from a domestically controlled RIC, including a distribution in liquidation or redemption, would nevertheless be taxable to foreign shareholders as attributable to the sale of a U.S. real property interest.

⁹ Treaties may reduce U.S. taxation on transfers by estates of foreign decedents.

readily tradable in a secondary market (or substantial equivalent). However, a PTP is still treated as a partnership, rather than a corporation, for tax purposes if at least 90 percent of its gross income consists of certain enumerated categories of passive-type income. Under prior law, no distinction was made between PTPs and other partnerships for purposes of applying the look-through rule.

The Act specifies that the look-through rule only applies to income from a partnership which is not a qualified PTP and modifies the definition of good income to include net income from a qualified PTP.¹⁰ A qualified PTP includes a PTP treated as a corporation as well as a PTP treated as a partnership if less than 90 percent of its gross income is derived from good income for a RIC. Thus, a RIC no longer needs to look through PTPs with income which could threaten qualification under the income source rules and can treat any income from such PTPs as good income. The Act provides that the existing asset diversification requirements apply to qualified PTPs similarly to other RIC investments and adds a new requirement that, at the end of any quarter, not more than 25 percent of a RIC's assets can be invested in qualified PTPs.¹¹ Thus, RICs will need to monitor the amount they invest in entities which would be considered qualified PTPs under these new rules. With respect to tax items attributable to a RIC's interest in a qualified PTP, the Act provides that the special rule for qualified PTPs under the passive activity loss rules (generally, requiring separate treatment) apply.

These changes eliminate the uncertainty that previously existed for fund complexes in how to treat PTPs for purposes of the RIC qualification tests. RICs previously had to carefully

monitor investments in PTPs which received income which might not qualify as good income. Elimination of the look-through rule for qualified PTPs and the inclusion of qualified PTP income as good income give RICs increased flexibility in pursuing their investment strategies and may facilitate the use of PTPs as vehicles to gain exposure to markets which might otherwise present qualification problems if accessed directly (e.g., commodities).¹²

The Act provides that these provisions are effective for taxable years beginning after October 22, 2004.

3. Translation of Foreign Taxes Paid by RICs

Under prior law, RICs generally were required to translate the amount of foreign taxes paid in foreign currencies into a U.S. dollar amount based on the average exchange rate for the taxable year to which the taxes related when determining the amount of the foreign tax credit. In spite of this technical requirement, many RICs of necessity had to translate the amount of foreign taxes paid based on a spot rate because of the daily pricing of their shares.

The Act corrects this problem by providing that RICs are to translate foreign income taxes paid or accrued using the exchange rate as of the date the income accrues.

This provision of the Act is effective with respect to taxable years beginning after December 31, 2004.

If you have any questions regarding this memorandum, please contact Thomas A. Humphreys at 212-839-5853, Jennifer Coates at 212-839-5422, or any other member of the Sidley Austin Brown & Wood LLP Tax Group

¹⁰ PTP income is included in both the numerator and denominator of the fraction for purposes of the 90 percent determination.

¹¹ An exception exists for discrepancies arising solely because of market value fluctuations.

¹² However, the 25 percent limitation on qualified PTP investments described above will restrict a RIC's ability to use PTP investments for this purpose.

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