INVESTMENT COMPANY INSTITUTE

MEMO# 3624

March 24, 1992

CONGRESS APPROVES, AND PRESIDENT VETOES, TAX BILL

11/ The pension simplification provisions are described in a separate memorandum to Pension Members. 22/ See Institute Memoranda to Tax Members No. 14-92, Closed-End Fund Members No. 12-92, Unit Investment Trust Members No. 17-92, Accounting/Treasurers Members No. 10-92, Operations Members No. 10-92, International Committee No. 6-92, Institutional Funds Committee No. 2-92, and Transfer Agent Advisory Committee No. 12- - 1 - March 23, 1992 TO: BOARD OF GOVERNORS NO. 19-92 TAX MEMBERS NO. 15-92 CLOSED-END FUND MEMBERS NO. 13-92 UNIT INVESTMENT TRUST MEMBERS NO. 20-92 ACCOUNTING/TREASURERS MEMBERS NO. 12-92 OPERATIONS MEMBERS NO. 11-92 INTERNATIONAL COMMITTEE NO. 7-92 INSTITUTIONAL FUNDS COMMITTEE NO. 3-92 TRANSFER AGENT ADVISORY COMMITTEE NO. 14-92 RE: CONGRESS APPROVES, AND PRESIDENT VETOES, TAX BILL ____
The tax bill that Congress approved, and President Bush vetoed, on Friday, March 20 contained numerous provisions of interest to regulated investment companies ("RICs") and their shareholders. Among the provisions of interest are those relating to (1) tax simplification for investment companies (e.g., repeal of the Code section 851(b)(3) "30 percent test" and the requirement to report cost basis to mutual fund shareholders), (2) expanded eligibility for deductible Individual Retirement Account ("IRA") contributions and creation of a new IRA to which nondeductible contributions could be made, (3) certain penalty-free withdrawals from IRAs, (4) modified taxation of capital gains, (5) foreign tax simplification, (6) repeal of investment restrictions applicable to nuclear decommissioning funds, (7) amortization of intangibles, (8) the amended "Taxpayer Bill of Rights", (9) certain administrative changes and (10) pension simplification1/1. This memorandum briefly describes the House-Senate compromise, which was passed by Congress and vetoed by President Bush (the "Conference Committee bill"). Previous memoranda describe provisions in the House and Senate tax bills in greater detail.2/2 Anyone interested in obtaining copies of relevant 92, dated March 16, 1992; and to Tax Members No. 12-92, Closed- End Fund Members No. 10-92, Unit Investment Trust Members No. 14- 92, Accounting/Treasurers Members No. 8-92, Operations Members No. 8-92, International Committee No. 4-92 and Transfer Agent Advisory Committee No. 11-92, dated March 2, 1992. - 2 - Conference Committee Report and statutory bill language may do so by calling the undersigned at (202) 955-3585. I. Tax Simplification for Investment Companies The Conference Committee bill contained all three provisions relating to tax simplification for investment companies that were contained in the House bill. First, the Conference Committee bill would have repealed the 30 percent test of Code section 851(b)(3). Second, the bill would have required mutual funds and brokers to generally report to mutual fund shareholders and the Internal Revenue Service ("IRS") the cost basis of shares redeemed, calculated under the single-category average cost method. As under the House bill, this reporting requirement

would have applied only to accounts opened on or after January 1, 1994, but would have excluded accounts containing shares acquired other than by purchase (such as by gift or inheritance). In addition, as under the House bill, a shareholder could have elected in the year of the first redemption from the account to use another cost basis method (either first-in, first-out or specific identification). The Conference Report indicated that the Conferees expected that the IRS would have consulted with representatives of the industries affected by the basis reporting provisions to develop regulations necessary to implement the provision. Third, the bill would have generally permitted a bank common trust fund with diversified assets to transfer its assets to a RIC in a tax-free conversion. II. Individual Retirement Accounts The Conference Committee bill included the IRA provisions that were contained in the Senate bill and that previously were contained in the "Bentsen-Roth" bill that was introduced in November 1991. Thus, the bill would have restored the universal income tax deduction for IRA contributions and created a "special IRA" under which contributions would not be deductible, but earnings on amounts remaining in the account for at least five years could be withdrawn tax-free. Individuals would have been allowed to convert their existing IRAs into "special IRAs" if income tax were paid on the earnings and previously-deducted contributions. - 3 - III. Penalty-Free Withdrawals The Conference Committee bill would have permitted penalty- free withdrawals from IRAs in several situations. First, penalty-free withdrawals of up to $10,000 would have been permitted for first-time home purchasers. The Conference Committee bill would have expanded the House bill, which permitted penalty-free withdrawals when the first-time homebuyer 33/ Unlike the House bill, the Conference Committee bill would not have provided for indexing the cost basis of capital assets for inflation. - 4 - was the taxpayer or the taxpayer's child, by also permitting withdrawals when the first-time homebuyer was the taxpayer's spouse or grandchild. Second, penalty-free withdrawals not in excess of the amount of qualifying educational expenses would have been permitted. The Conference Committee bill would have expanded the House bill's treatment by permitting penalty-free withdrawals for qualifying expenses of the taxpayer's child or grandchild without regard to whether they were dependents (as required by the House bill). Third, like the House and Senate bills, the Conference Committee bill would have permitted penalty-free withdrawals for qualifying medical expenses. Fourth, like the Senate bill, the Conference Committee bill would have provided that the rule permitting penalty-free withdrawals after an individual reaches age 59 1/2 would not apply to amounts contributed during the previous 5 years. Fifth, modifying a provision in the Senate bill, the Conference Committee bill would have permitted penalty-free withdrawals from IRAs by persons who had received unemployment compensation for 12 consecutive weeks, if such withdrawals were made during the year in which such unemployment compensation was received or the succeeding taxable year. This provision would not have applied to amounts withdrawn (1) from inherited IRAs or (2) that had been previously rolled over from a qualified retirement plan. Finally, the Conference Committee bill did not include the Senate provision that would have permitted penalty-free withdrawals for the purchase of new passenger automobiles and for living expenses of unemployed persons. IV. Modified Taxation of Capital Gains The Conference Committee bill contained two provisions that would have modified the taxation of capital gains. First, like the House and Senate bills, the Conference Committee bill would have excluded from tax 50 percent of the capital gains realized upon the disposition of qualified small business stock acquired by the taxpayer at its original issuance and held for more than five years. RIC shareholders would have been eligible to claim the 50 percent exclusion for gains on the sale of qualified small business stock originally issued to the RIC only if (1) the RIC held the stock for more than five years and (2) the RIC shareholder held the RIC stock on which the capital gain dividend was paid from the date the RIC acquired the qualified small business stock through the date the qualified small business stock was sold. Second, the Conference

Committee bill would have provided progressive capital gains tax rates for individuals. 3/3 A similar provision (with different rates) was included in the Senate bill. - 5 - Under the Conference Committee bill, the marginal rate on qualified capital gain would have been zero on gains otherwise taxed in the 15 percent bracket, 14 percent on gains 44/ These regulations, which the Institute generally supports, would permit nuclear decommissioning funds to invest in RICs which meet certain conditions regarding assets and conduct. (See Institute Memoranda to Tax Committee No. 27-90 and SEC Rules Committee No. 47-90, dated September 4, 1990; and to Tax Committee No. 38-90 and Institutional Funds Committee No. 6-90, dated December 20, 1990.) - 6 - otherwise taxed in the 28 percent bracket, 21 percent on gains otherwise taxed in the 31 percent bracket and 28 percent on gains otherwise taxed in the new 36 percent bracket. As under current law, capital gains realized upon the disposition of a RIC's portfolio securities would retain their character for purposes of reduced capital gains tax rates when distributed to the RIC's individual shareholders as capital gain dividends. As under the Senate bill, the entire amount of qualified capital gain would have been included in alternative minimum taxable income and the holding period for long-term capital gain treatment would have been increased from more than one year to more than two years. V. Foreign Investment Provisions The Conference Committee bill included provisions that were contained in the House and Senate bills for (1) taxing investments in passive foreign corporations ("PFCs") and (2) claiming the foreign tax credit when the amount of an individual's creditable foreign taxes is no more than $200. The mark-to-market system applicable to investments by RICs in PFCs would have generally eliminated the RIC-level tax that applies under existing law. Under a transition rule, also contained in the House and Senate bills, RICs would have been required to (1) mark to market all PFC stock in their portfolios on the first day of the RIC's first taxable year beginning after December 31, 1992, (2) pay a nondeductible interest charge on the tax that would have been collected had the PFC shares been marked to market in the prior years, and (3) distribute the mark-to- market gains to their shareholders. VI. Repeal of Investment Restrictions Applicable to Nuclear Decommissioning Funds The Conference Committee bill contained the provision in the Senate bill that would have expanded the investment options of nuclear decommissioning funds far beyond the scope of proposed Treasury regulations4/4 by completely eliminating the present-law investment restrictions that apply to nuclear decommissioning funds. - 7 - - 8 - VII. Amortization of Intangible Assets The Conference Committee bill included the House bill provision that would have required that the purchase price for certain intangible assets acquired from another party be amortized over a uniform 14-year period. Among the acquired intangible assets that would have been subject to the 14-year amortization period proposed under the bill were goodwill, going concern value and various customer-based intangibles, such as investment management contracts. Like the House bill, the Conference Committee bill would not have changed the tax treatment of costs incurred in the creation of intangible assets by a taxpayer, such as advertising expenses. VIII. Taxpayer Bill of Rights The Conference Committee bill adopted the Senate provision in the Taxpayer Bill of Rights which would have required that IRS Forms 1099 (and acceptable substitutes) sent to payees contain the name, address and phone number of the payor's "information contact." In addition, like the Senate bill, the Conference Committee bill would have generally provided relief from retroactive application of Treasury regulations, unless a taxpayer elected to apply the regulations retroactively. IX. Administrative Provisions The Conference bill contained two administrative changes of interest to RICs that were included in the House and Senate bills. First, the bill would have modified the rules for determining when to deposit amounts withheld under backup withholding. Second, the bill would have redefined the term "reproduction" (for purposes of certain recordkeeping requirements) to include a reproduction from a digital image. * * * We will keep you informed of developments. Keith

D. Lawson Associate Counsel - Tax