

MEMO# 5040

August 9, 1993

CONGRESS APPROVES TAX BILL

August 9, 1993 TO: BOARD OF GOVERNORS NO. 70-93 RE: CONGRESS APPROVES TAX BILL

Friday evening, Congress gave final approval to the Omnibus Budget Reconciliation Act of 1993 (H.R. 2264). Several of the Act's provisions are of interest to regulated investment companies ("RICs") and their shareholders.

1. Provisions to Prevent Conversion of Ordinary Income to Capital Gain A. Ordinary Income Treatment for All Market Discount Of particular importance to tax-exempt bond funds, the Act treats any market discount recognized on a tax-exempt bond as taxable ordinary income and not capital gain, as was previously the rule. Ordinary income treatment is also required for market discount on bonds issued on or before July 18, 1984; taxable bonds issued after that date are already subject to ordinary income treatment. These changes are effective for obligations purchased after April 30, 1993. B. Recharacterization of Gain in "Conversion Transactions" The Act converts gain on the sale or exchange of a capital asset that is held as part of a "conversion transaction" to ordinary income. According to the Conference Report, the taxpayer in a conversion transaction "is in the economic position of a lender - he has an expectation of a return from the transaction which in substance is in the nature of interest and he undertakes no significant risks other than those typical of a lender." These new gain recharacterization provisions apply to conversion transactions entered into after April 30, 1993. It appears that this legislation could have an impact on those funds holding short-term debt instruments that have been promoted as vehicles for converting ordinary income into capital gain. These funds typically minimize their ordinary income distributions to shareholders by making maximum use of the dividends paid deduction for amounts paid out on redemption, a practice known as "tax equalization."

2. Targeted Capital Gains Exclusion Under the Act, an individual investor who acquires stock at original issue in a corporation with gross assets of \$50 million or less (a "qualified small business") and holds the stock for more than 5 years, either directly or through a pass-through entity such as a RIC, is permitted (subject to certain limitations) to exclude from income 50 percent of any gain realized upon the disposition of the stock. In the case of a RIC investor, the qualified small business stock must be (1) acquired by the RIC after the investor's RIC shares are purchased and (2) disposed of more than 5 years after the stock is acquired and while the RIC investor continues to hold his shares in the RIC.

3. Amortization of Intangibles The Act also provides that the purchase price of certain acquired intangible assets is to be amortized over a uniform 15-year period. The Treasury Department is given authority to reduce this period for rights that have a fixed duration of less than 15 years. Among the intangible assets covered by the Act are goodwill, going concern value and various customer- based intangibles, including investment management contracts. The provision is generally effective for property acquired after the date of enactment, although a taxpayer can elect to have the Act apply to all property acquired after July 25, 1991.

4. Denial of Deduction for Lobbying Expenses The Act disallows any deduction for amounts paid or incurred in connection with (1) influencing Federal or State

legislation or (2) any communication with certain senior Federal executive branch officials in an attempt to influence the official actions or positions of such officials. The Act defines "influencing legislation" as "any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of legislation." Also disallowed as deductions are amounts "paid or incurred for research for, or preparation, planning, or coordination of, any lobbying activity." The disallowance for non-legislative communications with certain senior Federal executives is limited to direct communications with the President, the Vice President, Cabinet-level officials and their deputies, the two most senior-level officials of each agency within the Executive Office of the President and the White House staff. The deduction disallowance applies to the portion of membership organization dues which is allocable to such lobbying and political expenditures. A trade association is required to provide annual information disclosure (but not on IRS Forms 1099) to members regarding lobbying expenditures, unless the association elects to pay a proxy tax computed at the top corporate tax rate (35 percent) on the amount of its lobbying expenditures for the year. In addition, an association must disclose on its annual tax return, whether or not it pays the proxy tax, the amount of its lobbying expenditures. These changes apply to amounts paid or incurred after December 31, 1993. The Institute will provide information in the near future regarding the effect of this provision on Institute dues. 5. Compensation Limits for Retirement Plans Under the Act, the amount of compensation that can be taken into account under retirement plans will be reduced to \$150,000, effective for benefits accruing in plan years beginning after December 31, 1993. The \$150,000 limit will be adjusted for inflation, but only in increments of \$10,000. * * * A more detailed memorandum, with attachments, is being distributed to Tax Members, Accounting/Treasurers Members and Pension Members. Please contact Keith Lawson (202/955-3585) or Kathy Ireland (202/955-3516) for additional information. We will keep you informed of developments. Matthew P. Fink President