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HOUSE APPROVES TAX FAIRNESS AND ECONOMIC GROWTH ACT OF 1992

11 The bill, H.R. 4210, is titled the "Tax Fairness and Economic Growth Act of 1992." 22 The IRA withdrawal and pension simplification provisions are discussed separately in Institute Memorandum to Pension Members No. 3-92, dated February 27, 1992. March 2, 1992 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 TRANSFER AGENT ADVISORY COMMITTEE NO. 11-92 RE: HOUSE APPROVES TAX FAIRNESS AND ECONOMIC GROWTH ACT OF 1992 _____ The House of Representatives has approved, by a vote of 221-209, major tax legislation11 that would have a significant impact on investment companies. Among the provisions of interest to investment companies are those relating to tax simplification for investment companies (e.g., repeal of the Code section 851(b)(3) "30 percent test" and the requirement on mutual funds to report shareholder basis), modified taxation of capital gains (e.g., indexing the basis of capital assets for inflation), foreign tax simplification (e.g., passive foreign corporation "anti-deferral" rules and simplification of the foreign tax credit limitation), amortization of intangibles, penalty-free withdrawals from individual retirement accounts ("IRAs"), pension simplification22 and the amended "Taxpayer Bill of Rights". The following is a summary of the provisions of the bill which affect regulated investment companies ("RICs") and their shareholders. The relevant portions of the bill and the Technical Explanation are attached. I. The Mutual Fund Tax Simplification Bill - 1 - The House-passed bill contains two provisions (repeal of the 30 percent test and the requirement that mutual funds report average cost basis information to certain shareholders) that were part of the mutual fund tax simplification bill introduced in June 1991 by House Ways and Means Committee Chairman Rostenkowski, Congressman Archer, the ranking minority member on the Committee, and others. (See Institute Memorandum to Tax Committee No. 20-91, Operations Committee No. 21-91, Accounting/Treasurers Committee No. 14-91 and Transfer Agent Advisory Committee No. 31-91, dated June 25, 1991). The section of the mutual fund tax simplification bill which provided that expense reimbursements would be disregarded for purposes of the qualifying income test of Code section 851(b)(2) is not included in the 1992 tax bill. However, the House-passed bill does contain a provision which would permit tax-free conversions of bank common trust funds into RICs that was not part of the mutual fund tax simplification bill, but was included in a financial services reform bill that likewise was not enacted last year. A. Repeal of the 30 Percent Test (Attachment A) The House-passed bill would repeal the 30 percent test of Code section 851(b)(3) for taxable years ending after the bill's date of enactment. B. Shareholder Basis Reporting (Attachment B) The bill would amend the reporting requirements of Code section 6045 to impose upon mutual funds and brokers, which are presently required to report gross proceeds on sales

or exchanges of mutual fund shares, the obligation to provide to shareholders and the Internal Revenue Service ("IRS") average cost basis information for shares redeemed. Consistent with the current reporting requirements of Code section 6045, basis information would be provided to shareholders by January 31, and to the IRS by February 28, of the year following the year of redemption. This reporting requirement would apply, however, only to accounts opened on or after January 1, 1994. The average cost information would be provided using the "single-category" method, which computes the average cost for all of the taxpayer's shares and then determines the holding period of shares sold on a first-in, first-out basis. Regulatory authority is provided to determine the manner in which basis and holding periods would be reported. Such authority would include the authority to require funds and brokers to take into account wash sales, return of capital distributions and other events that might affect a basis calculation. All basis calculations would be done on an account-by- account basis. Funds and brokers would not be required to provide average cost information for any account that contains - 2 - shares acquired other than by purchase (such as by gift or inheritance). Any broker that holds fund shares as a nominee for another person and transfers the shares to another broker would, however, be required to provide cost basis information to the second broker. The cost basis provisions of Code section 1012 would be amended to require fund shareholders to use the cost basis information provided in calculating gain or loss on the sale of fund shares, unless the shareholder 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). Under the bill, shareholders could elect different cost basis methods for different accounts in the same fund. Special rules are also provided regarding the information reporting penalty provisions of Code sections 6721 through 6724. First, the bill provides that the amount "required to be reported" for purposes of determining the penalty for intentional disregard of reporting requirements would be computed without regard to basis amounts reported. Second, the explanation of provisions contemplates that amended basis reports may be necessary in certain cases, such as certain wash sales. C. Tax-Free Conversions of Bank Common Trust Funds (Attachment C) The 1992 tax bill would generally permit a bank common trust fund with diversified assets to transfer its assets to a RIC in a tax-free conversion. The transfer must be solely in exchange for RIC shares which must then be distributed to the fund's participants (also tax-free) in exchange for the participants' interests in the fund. The basis of the RIC's assets will be the same as the common trust fund's basis in its assets. The RIC shareholders' basis in their RIC shares will be the same as the basis in their common trust fund interests. II. Modified Taxation of Capital Gains A. Indexing (Attachment D) The bill would permit taxpayers other than corporations to index the basis of certain assets acquired on or after February 1, 1992. In the case of RIC investments, indexing adjustments could be made at both the RIC level and the shareholder level. In most respects, the indexing provisions in the 1992 House- passed bill are comparable to the indexing provisions contained in the bill that passed the House in 1989. (See Institute Memorandum to Tax Members No. 32-89, Closed-End Fund Members No. 43-89, Unit Investment Trust Members No. 49-89, Accounting/Treasurers Committee No. 38-89, Operations Committee No. 17-89 and Transfer Agent Advisory Committee No. 24-89, dated September 27, 1989.) - 3 - - 4 - 1. Indexing in General The bill would provide that for purposes of determining gain (but not loss) on the sale or disposition by a taxpayer other than a corporation of an "indexed asset" which was held for more than one year, the indexed basis of the asset would be substituted for its adjusted basis. The term "indexed asset" would be defined generally as any stock in a corporation and any tangible property which was a capital asset or used in a trade or business and was acquired on or after February 1, 1992. The term "indexed asset" would not include, among other things, debt, collectibles, options, and stock in a foreign corporation (unless, in general, that stock was regularly traded on a U.S. national or

regional exchange). Any taxpayer holding a readily tradable security acquired prior to February 1, 1992 who desired to index the security for future inflation could elect to mark the asset to market as of February 1, 1992. Gain on any security for which the mark-to-market election had been made would be taxable, while loss on any security for which the election had been made would be disallowed. The indexed basis for any asset would be the asset's adjusted basis multiplied by the "applicable inflation ratio." To compute the applicable inflation ratio, the consumer price index ("CPI") for the calendar year preceding the calendar year in which the disposition took place would be divided by the CPI for the calendar year preceding the calendar year in which the taxpayer's holding period for such asset began. The applicable inflation ratio would be disregarded if it were less than 1. A "convention" would be provided in the bill whereby all assets disposed of during a calendar year would be treated as disposed of on the last day of that year. Under this convention, to the extent that the date of disposition was moved forward, the date of acquisition would correspondingly be moved forward. For example, if an asset were acquired on October 1, 1992 and sold 33 months later on June 30, 1995, under the convention the asset would be treated as sold on December 31, 1995 and acquired on April 1, 1993 (i.e., 33 months prior to the deemed disposition date). Consequently, indexing would be permitted to the extent that the CPI increased from 1992 (the calendar year preceding the year of the deemed acquisition) to 1994 (the calendar year preceding the year of the deemed disposition). The bill also would provide two special short sale rules. First, if an indexed asset were sold short and the sale was not closed for more than one year, the amount realized would be increased by the applicable inflation ratio. Second, if a taxpayer sold short property substantially identical to an asset - 5 - held by the taxpayer, neither the asset held by the taxpayer nor the substantially identical property would be treated as an indexed asset during the short sale period. 2. Special Indexing Rules for RICs and Their Shareholders For RIC investments, indexing would generally apply at both the RIC level and at the RIC shareholder level. A RIC would be permitted to index its basis in all indexed assets. Indexing would apply in the computation of both the RIC's taxable income and its earnings and profits. Thus, a RIC would be required generally to distribute to its shareholders only its gains after indexing. Indexing would not apply, however, in computing income for purposes of the RIC qualification test (e.g., sections 851(b)(2) and (b)(3)). In addition, to the extent that a RIC retained capital gains that were not designated pursuant to section 852(b)(3)(D), the corporate level tax imposed under section 852(b)(3)(A) would be increased to eliminate the benefit of the indexing adjustment. Because a RIC's corporate shareholders would not be eligible for indexing, the bill would effectively treat these shareholders as having received distributions equal to what they would have received had indexing adjustments not been made at the RIC level. A RIC's non-corporate shareholders would be permitted in general to index their RIC stock for any calendar month in the same ratio as the fair market value of the indexed assets held by the RIC at the close of such month bore to the fair market value of all of the RIC's assets at the close of such month. Under safe harbors in the bill, the ratio for any month would be deemed to be 100 percent if the actual ratio for the calendar month were 90 percent or more. Conversely, if the ratio for any calendar month were 10 percent or less, the ratio for such month would be zero. B. Capital Gains Exclusion on Certain Small Business Stock (Attachment E) The bill provides a 50 percent exclusion from tax for capital gains realized upon the disposition of qualified small business stock acquired by the taxpayer at its original issuance, on or after February 1, 1992, and held for more than five years. A qualified small business would be defined as a domestic corporation with an aggregate capitalization of not more than $100 million that is engaged in an active trade or business and that employs substantially all of its assets in the active conduct of a trade or business. Neither RICs nor corporations with more than 10 percent of their assets in portfolio stock investments could be treated as qualified small businesses. - 7 - RIC

shareholders would be eligible to claim the 50 percent exclusion for gains on the sale of qualified small business stock originally issued to the RIC if the RIC held the stock for more than five years and the 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. III. Foreign Investment Provisions The bill contains provisions relating to foreign investment that are substantially similar to provisions of the "Tax Simplification Act of 1991" and of interest to RICs and their shareholders. (See Institute Memorandum to Tax Members No. 23- 91, Closed-End Fund Members No. 27-91, International Committee No. 11-91 and Accounting/Treasurers Committee No. 16-91, dated July 1, 1991.) A. Passive Foreign Corporations (Attachment F) The bill creates a new definition, the passive foreign corporation or "PFC", which replaces, among other definitions, the definition of a PFIC. A PFC is any foreign corporation if (1) 60 percent or more of its gross income is passive income (compared to a 75 percent requirement under the current PFIC definition), (2) 50 percent or more of its assets by value (measured on average over the year) produce or are held for the production of passive income, or (3) it is registered under the Investment Company Act of 1940 as either a management company or a unit investment trust. Under a new election, PFCs which meet certain requirements can elect to be treated as foreign corporations. The bill adds a mark-to-market system of taxation of PFICs to the two existing tax regimes for PFICs, current inclusion under the qualified electing fund or "QEF" rules and the deferred interest charge method. As proposed, QEF rules will be available to any U.S. person owning less than 25 percent of the stock of a PFC that is not U.S. controlled (U.S. control is generally defined as five or fewer U.S. persons owning more than 50 percent of the PFC stock). Shareholders not electing QEF treatment are subject to one of two methods for taxing the economic equivalent of the PFC's current income. Under the bill, the mark-to-market system will be mandatory for all taxpayers holding marketable PFC stock. For these purposes, all PFCs held by open-end registered investment companies will be considered marketable, as will such stock held by a closed-end fund, unless the Internal Revenue Service promulgates regulations which disallow such treatment for closed- end funds. - 8 - Gains on PFIC stock will be recognized in full as ordinary gain. Mark-to-market losses will be ordinary to the extent of prior net gains, referred to in the bill as "unreversed inclusions". Mark-to-market losses in excess of unreversed inclusions will be suspended (i.e., no basis adjustment is made in that year and no loss is recognized). In addition, upon actual disposition, loss will be treated as ordinary to the extent of unreversed inclusions. However, losses in excess of unreversed inclusions will be treated as capital losses upon disposition. RICs which hold PFIC stock on the first day of the RIC's first taxable year beginning after December 31, 1992, will not be subject to tax on any gain, but will be required to pay a non- deductible interest charge in an amount equal to the interest which would be owed if the deferred interest charge method applied. The mark-to-market rules would then apply from that point forward. Under special RIC rules, mark-to-market gain is treated as a dividend for purposes of the 90 percent test of Code section 851(b)(2) and the 30 percent limitation of section 851(b)(3). This provision of the bill would be generally effective for taxable years of U.S. persons beginning after December 31, 1992, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. B. Foreign Tax Credit Limitation (Attachment G) Consistent with the Institute's prior requests, the bill would allow individuals with no more than $200 of foreign taxes which can be claimed as a credit and with no foreign source income other than passive income (i.e., dividends, interest, etc.) to elect a simplified foreign tax credit limitation equal to the lesser of the actual foreign taxes paid or 25 percent of the individual's foreign source income. (See Institute Memorandum to Tax Committee No. 2-91, dated January 30, 1991.) The explanation to the bill specifically states that a Form 1116, the individual foreign tax credit reporting form, should not be required. The simplified

limitation will only be available to persons who receive a payee statement, such as a Form 1099, with the amount of the foreign taxes reported on the form. This provision would apply to taxable years beginning after December 31, 1991. IV. Amortization of Intangible Assets (Attachment H) The House-passed bill also contains a provision similar to that introduced by Chairman Rostenkowski of the House Ways and Means Committee to require that the purchase price for certain intangible assets acquired from another party be amortized over a - 9 - uniform 14-year period. (See Institute Memorandum to Members - One Per Complex No. 32-91, Tax Members No. 32-91 and Accounting/Treasurers Members No. 20-91, dated July 31, 1991.) Like the original Rostenkowski bill, the House-passed bill does not change the tax treatment of costs incurred in the creation of intangible assets by a taxpayer, such as advertising expenses. Among the acquired intangible assets subject to the 14-year amortization period proposed under the bill are goodwill, going concern value and various customer-based intangibles, such as investment management contracts. The acquisition costs for some of these assets are not currently amortizable. Where amortization is permitted under current law, the amortization period is based on a factual determination of the asset's useful life and can, therefore, become a subject of dispute between taxpayers and the IRS. The bill would generally apply prospectively, to intangible assets acquired after the date of the bill's enactment. However, taxpayers could elect to apply the rules to either (1) all property acquired after July 25, 1991 or (2) all property acquired in certain taxable years for which the statute of limitations has not expired. The amortization period would be 14 years if the first election were made and 17 years (beginning with the month that the intangible asset was acquired) if the second election were made. In addition, a taxpayer could elect to apply present law (rather than the bill) to property acquired after date of enactment pursuant to a binding written contract in effect on February 14, 1992. V. Taxpayer Bill of Rights Amendments (Attachment I) One provision in the Taxpayer Bill of Rights would require payors such as funds to include their telephone numbers on information returns sent to taxpayers. This provision would apply to statements required to be furnished after December 31, 1992. VI. Penalties for Failure to Provide Reports Relating to Pension Payments (Attachment J) The bill would conform the information reporting penalties that apply with respect to pension payments to the general information reporting penalty structure by incorporating into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients. This provision would apply to returns and statements the due date for which is after December 31, 1992. - 10 - * * * We will keep you informed of developments concerning this legislation. Keith D. Lawson Associate Counsel - Tax Attachments KDL:bmb