

MEMO# 7580

January 25, 1996

CLINTON ADMINISTRATION TAX PROPOSALS

January 25, 1996 TO: TAX COMMITTEE No. 4-96 OPERATIONS COMMITTEE No. 2-96
TRANSFER AGENT ADVISORY COMMITTEE No. 5-96 RE: CLINTON ADMINISTRATION TAX PROPOSALS

As part of the ongoing budget negotiations, the Clinton Administration has proposed a number of tax law changes designed to raise revenues. Several of these changes, including those discussed below, could affect regulated investment companies ("RICs") and their shareholders. At this time, it is unclear whether the negotiations will produce an agreement and, if so, whether the resulting bill would include any of the Administrations proposals. 1. "Short Against The Box" Proposal (Attachment A) One Administration proposal would require a taxpayer holding an appreciated position in either stock, a debt instrument or a partnership interest to recognize gain, but not loss, upon entering into a "constructive sale" of the position. For these purposes, a constructive sale would be deemed to occur when a taxpayer "substantially eliminates risk of loss and opportunity for gain by entering into one or more positions with respect to the same or substantially identical property." The proposal would apply, among other things, to situations where a taxpayer holding appreciated stock: (a) sold the stock short (a "short against the box"), (b) entered an equity swap with respect to the stock, (c) granted a call option or acquired a put option on the stock where there was a substantial certainty that the option would be exercised or (d) entered into a transaction that was marketed or sold as substantially eliminating the risk of loss and opportunity for gain. The proposal would not apply, however, to certain transactions involving property that is not "marketable," to transactions subject to the securities dealer mark-to-market rules of Internal Revenue Code section 475 or to transactions subject to the mark-to-market rules of section 1256. A taxpayer holding property subject to the proposed constructive sale rule would be treated as having sold and immediately repurchased the appreciated property and would receive a new basis and holding period in the property. If a taxpayer entered into a constructive sale with respect to less than all of his or her appreciated positions in the property, gain would be triggered by treating the property first acquired as the first sold. This proposal would be effective for constructive sales entered into after the proposal's date of enactment. In addition, if a constructive sale were entered into after January 12, 1996 and before date of enactment, and not closed before 30 days after date of enactment, a constructive sale would be deemed to occur on the date that was 30 days after date of enactment. 2. Dividends Received Deduction (Attachment B) The Administration has proposed two changes to the dividends received deduction. First, the 70 percent deduction for dividend recipients holding less than 20 percent of the payor's stock would be reduced to 50 percent. Second, the deduction generally would be unavailable if the dividend recipient was protected from

risk of loss at the time the dividend was paid. Both of these changes would be effective for dividends received or accrued after January 31, 1996. 3. Information Return Failure to File Penalties (Attachment C) Another proposal would increase the maximum penalty for failure to file correct information returns -- currently set at \$50 per return -- to the greater of \$50 per return or 5 percent of the total amount required to be reported. The increased penalty would not apply if the total amount actually reported was at least 97 percent of the amount required to be reported. The proposal would apply to returns the due date for which (without regard to extensions) was more than 90 days after date of enactment. 4. Conversions of Subchapter C Corporations (Attachment D) The Administration also would modify the rules under section 1374 requiring that gain be recognized, upon the conversion of a Subchapter C corporation to a Subchapter S corporation, only to the extent that assets held on the conversion date are sold within the next ten years. Specifically, the proposal would repeal section 1374, and require current gain recognition, for any conversion involving a Subchapter C corporation with stock valued at more than \$5 million at the time of conversion. The proposal would apply to conversions on or after December 7, 1995. Although section 1374 does not apply, by its terms, to transactions involving RICs, the Internal Revenue Service ("IRS") has applied "analogous" rules to mergers of non-RICs into RICs. If Congress were to repeal section 1374 for conversions involving corporations valued at more than \$5 million, IRS might take the position that "analogous" rules under section 1374 no longer existed to permit non-RICs with values of more than \$5 million to merge tax-free with RICs. * * * * * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachments

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