MEMO# 7739

March 26, 1996

TAX PROPOSALS IN PRESIDENT CLINTON'S BUDGET PROPOSAL

1 See Institute Memorandum to Tax Committee No. 4-96, Operations Committee No. 2-96 and Transfer Agent Advisory Committee No. 5-96, dated January 25, 1996. 2 See Institute Memorandum to Pension Members No. 47-95, Operations Committee No. 33-95 and Transfer Agent Advisory Committee No. 59-95, dated November 20, 1995. March 26, 1996 TO: CLOSED-END FUND COMMITTEE No. 7-96 OPERATIONS MEMBERS No. 12-96 PENSION MEMBERS No. 15-96 TAX MEMBERS No. 13-96 TRANSFER AGENT ADVISORY COMMITTEE No. 15-96 UNIT INVESTMENT TRUST COMMITTEE No. 10-96 RE: TAX PROPOSALS IN PRESIDENT CLINTON’S BUDGET PROPOSAL

____ President Clintons budget proposal for the fiscal year beginning October 1, 1996 includes several tax and pension provisions of interest to regulated investment companies ("RICs") and their shareholders. Many of these provisions were included in a Clinton Administration budget proposal made earlier this year.1 Other provisions were included in last fall’s vetoed budget bill.2 1. Requirement To Compute Cost Basis Using The Average Cost Method (Attachment A) One new Clinton Administration proposal generally would eliminate the present-law option that sellers of securities (including stocks, debt instruments, options, certain futures contracts and certain other derivative financial instruments) have to compute cost basis using either the specific- identification or the first-in-first-out ("FIFO") method. Instead, all securities sellers -- including RICs and their shareholders -- would be required to compute cost basis using the single-category average cost method that is available today, as an option, only to mutual fund investors. However, no obligation would be placed on brokers or other persons (including RICs) effecting securities sales (e.g., share redemptions) to calculate and/or report the average cost basis of securities sold. Under the single-category average cost method, an investor would add together the cost bases of all "substantially identical" securities and divide by the number of securities held to determine the average cost basis. For example, if an investor purchased 50 shares of XYZ stock at $ 10 per share and later purchased 50 shares at $ 20 per share, the average cost basis of the shares would be $ 15. The holding period for securities sold would be determined on a FIFO basis. The change is proposed to be effective for all securities sales (regardless of the date on which the securities were purchased) that occur after the 30th day following the date the provision is enacted. 2. "Short Against The Box" Proposal (Attachment B) The budget proposal includes the previously-announced Clinton Administration proposal to 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 holding an appreciated financial position (1) "enters into one or more positions with respect to the same or substantially identical property which, for some period, substantially eliminate both risk of loss and opportunity for gain on the appreciated financial position" or (2) "enters into any other transaction which is marketed or sold as being economically equivalent [to a transaction described above]." 3 All section references are to the Internal Revenue Code, unless otherwise noted. 4 See Institute Memorandum to Tax Members No. 9-88, dated February 12, 1988. 5 See Institute Memorandum to Tax Committee No. 7-96, dated February 29, 1996. 6 Under the proposal, however, the IRA contribution limit would be coordinated with the current law limits on elective deferrals under section 401(k) plans and tax-sheltered annuities. 7 The proposal, however, would impose the 10-percent early withdrawal tax on individuals over 59 1/2 who withdraw amounts attributable to contributions made during the previous five years that do not qualify as special purpose withdrawals. 2 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 or (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. 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 section 4753 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. 3. Dividends Received Deduction (Attachment C) The budget proposal also contains two previously-announced proposed changes to the dividends received deduction. First, the 70 percent deduction for dividends received by corporations 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. Under a modified effective date provision, these changes would apply to dividends received or accrued more than 30 days after the date of enactment. 4. Information Return Failure to File Penalties (Attachment D) Another previously-announced 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 aggregate amount required to be reported correctly but not so reported. The increased penalty would not apply if the total amount actually reported for the calendar year was at least 97 percent of the amount required to be reported. In addition, the proposal would not change the $250,000 calendar-year cap on penalties for failure to file correct information returns. The proposal would apply to returns the due date for which (without regard to extensions) was more than 90 days after date of enactment. 5. Conversions of Subchapter C Corporations (Attachment E) The budget proposal also contains a previously-announced proposal to 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 after January 1, 1997. Although section 1374 does not apply, by its terms, to transactions involving RICs, in IRS Notice 88-19 the Internal Revenue Service

("IRS") applied "analogous" rules to conversions and mergers of non-RICs into RICs.4 Treasury recently announced that, if Congress repeals section 1374 for conversions involving corporations valued at more than $5 million, the 1988 Notice will be updated so that non-RICs with values of more than $5 million will not be permitted to convert into or merge with RICs on a tax-free basis.5 In the same announcement, Treasury indicated that a separate IRS Notice (No. 88-96) -- relating to an exception from Notice 88-19 for single-year disqualifications from Subchapter M -- will not be affected by the proposed change. 6. Extend Pro Rata Disallowance of Tax-Exempt Interest Expense to All Corporations (Attachment F) Under another previously-announced proposal, corporations investing in tax-exempt obligations generally would be disallowed deductions for a portion of their interest expense equal to the portion of their total assets that is comprised of tax-exempt investments. For example, if one percent of a corporate taxpayer*s assets were tax-exempt bonds, one percent of the taxpayer*s interest expense would be disallowed. This proposal would be effective for taxable years after the date of enactment with respect to obligations acquired after December 7, 1995. 7. IRA Expansion (Attachment G) The budget proposal also contains IRA expansion, a new small employer retirement vehicle and pension simplification items similar to items proposed by the Administration in 1995 and similar to items in last fall’s vetoed budget bill. IRA expansion items include proposals to (1) expand eligibility for deductible IRAs by doubling the Adjusted Gross Income thresholds and phase-out ranges and indexing these thresholds and the present annual contribution limit of $2,000 for inflation,6 (2) eliminate the 10% early withdrawal penalty for certain special purpose withdrawals from IRAs7 and (3) establish a new, back- loaded "Special IRA." Contributions to this Special IRA, which would be permitted in amounts up to $2,000 (offset against contributions to the deductible IRA), would not be tax deductible, but distributions of the contributions would be tax-free. For contributions remaining in the Special IRA account for five years, distribution of the earnings on the contributions also would be tax-free. Withdrawals during the five-year period would be subject to ordinary income tax and 8 See Institute Memorandum to Pension Members No. 33-95, dated June 14, 1995. 9 Congress’ small employer plan (the "SIMPLE"), which was included in its 1995 bill, would have eliminated SEPs and SARSEPs. 3 the 10% early withdrawal penalty tax, unless special purpose withdrawal criteria are satisfied. The Administration continues to propose a January 1, 1996 effective date for its IRA proposals. 8. National Employees Savings Trust ("NEST") (Attachment H) The Administration also continues to propose a new simplified retirement plan for small employers called the National Employees Savings Trust ("NEST").8 The NEST proposal, which would be available to employers with fewer than 100 employees, minimizes administrative and compliance burdens. NEST accounts would be individual IRAs and incorporate design-based nondiscrimination safe harbors similar to those proposed for 401(k) plans in the Administration*s pension simplification package. All contributions would be immediately vested and fully portable. Withdrawals from these accounts would be restricted for two years. NESTs would not be subject to top-heavy or nondiscrimination testing rules (including ADP, ACP, and rules applying to SEPs and SARSEPs). This proposal clarifies that the NEST is not intended to replace the current SEP and SARSEP vehicles.9 9. Pension Simplification (Attachment I) The Administration also continues to include numerous pension simplification items in its budget. These measures generally have had bipartisan support, and have been included in previously vetoed, broader budget bills. These measures would, among other things, (1) enable tax-exempt organizations to establish 401(k) plans, (2) repeal five-year averaging for lump sum distributions, (3) simplify the taxation of annuity distributions, (4) delay the required application of the minimum distribution requirements for qualified plan distributions for individuals over 70 1/2 who continue to be employed, (5) simplify the definition of "highly compensated employee", repeal the related family aggregation rules, and modify the definition of "leased employee", (6) repeal the minimum participation rule for defined contribution plans, (7) provide design-based safe harbors for 401(k) nondiscrimination purposes and modify the current nondiscrimination testing rules, (8) repeal the section 415(e) combined plan maximum contribution limit, (9) modify rules applying to section 457 plans, including the imposition of a trust requirement on state and local government plans, (10) change all references to ages 59 1/2 and 70 1/2 to 59 and 70, and (11) eliminate the requirement that all summary plan descriptions be filed with the Department of Labor. Most, but not all, of these items have a proposed effective date of January 1, 1997. * * * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Russell G. Galer Assistant Counsel - Pension Attachment Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute’s Information Resource Center at (202)326-8304, and ask for this memo’s attachment number: 7739.
