

MEMO# 12829

November 3, 2000

IRS ISSUES GUIDANCE ON QUALIFIED 5-YEAR GAIN RULES

[12829] November 3, 2000 TO: TAX MEMBERS No. 33-00 TRANSFER AGENT ADVISORY COMMITTEE No. 57-00 ACCOUNTING/TREASURERS COMMITTEE No. 41-00 RE: IRS ISSUES GUIDANCE ON QUALIFIED 5-YEAR GAIN RULES The Internal Revenue Service ("IRS") has released guidance, requested by the Institute,¹ regarding implementation by regulated investment companies ("RICs") and their shareholders of the new "qualified 5-year gain" rules, enacted in 1997,² that become effective after December 31, 2000. Under these rules, the capital gains tax rate applicable to taxpayers in the 15-percent tax bracket will be reduced from 10 percent to 8 percent for any asset held for more than 5 years and sold after December 31, 2000. For taxpayers in higher tax brackets, the capital gains tax rate will be reduced from 20 percent to 18 percent for any asset acquired after December 31, 2000 (or marked to market at the beginning of 2001) and held for more than 5 years. The guidance released to date is included in two formats: the IRS Form 1099-DIV for 2001 (and accompanying instructions) and the instructions to IRS Form 4797 for 2000. We have been advised by IRS that guidance also will be included in the instructions to the Schedule D for IRS Form 1120-RIC; release of these instructions has been delayed because of technical corrections legislation pending in the Congress that would clarify a few aspects of the qualified 5-year gain rules.³

¹ See, e.g., Institute Memorandum to Tax Members No. 21-00, Accounting/Treasurers Committee No. 28-00 and Transfer Agent Advisory Committee No. 35-00, dated July 26, 2000. ² See Institute Memorandum to Tax Members No. 27-97, Accounting/Treasurers Members No. 31-97 and the Transfer Agent Advisory Committee No. 36-97, dated August 1, 1997. Specifically, these new rules were added by section 311 of the Taxpayer Relief Act of 1997 as amendments to section 1(h)(2) of the Internal Revenue Code. ³ The technical corrections legislation would provide that the mark-to-market election for assets acquired prior to 2001 "shall not apply to any asset which is disposed of . . . before the close of the 1-year period beginning on the date that the asset would have been treated as sold under such election." Section 724(c) of H.R. 5542 (the "Taxpayer Relief Act of 2000"). In addition, the bill's explanation (i.e., the Statement of Managers) "clarifies" that "the deemed sale and repurchase by reason of the election is not taken into account in applying the wash sale rules of section 1091."

²Form 1099-DIV The IRS Form 1099-DIV for 2001, which will be used by RICs to report distributions that are includable on shareholders' 2001 tax returns, includes a box (2c) in which a RIC would report that portion of its capital gain dividend attributable to gains on assets held for more than 5 years (other than gain arising from collectibles ("collectibles gain"), certain depreciable real property ("unrecaptured section 1250 gain"), and qualified small business stock). Each individual shareholder is responsible for determining, based upon the individual's income, whether the gain reported in 2001 in box 2c is taxable to him or her at an 8 percent rate (as qualified 5-year gain in the hands of a 15-percent rate taxpayer) or at a 20 percent rate.

Form 4797 Guidance regarding the qualified 5-year gain rules also is included in IRS instructions to Form 4797 ("Sales of Business Property") for 2000. We are pleased to inform you that the instructions clarify that both RICs and RIC shareholders may elect to mark to market securities held on December 31, 2000. RICs may mark their portfolio securities to market, and RIC shareholders may mark their RIC shares to market, by making the mark-to-market election on the tax return for the year that includes January 1, 2001. In general, any specific asset for which the mark-to-market election is made would be treated as sold at its closing market price on January 2, 2001.⁴ To elect this mark-to-market treatment, the taxpayer would attach a statement to the tax return indicating that the election is being made under section 311 of the Taxpayer Relief Act of 1997 and specifying those assets for which the election is being made. The return must be filed no later than its due date (including extensions). In addition, if a return is timely filed without an election for any asset, a taxpayer may still make the mark-to-market election by filing an amended return within 6 months of the due date of the return (excluding extensions). Once made, an election for any asset is irrevocable. The instructions also clarify that any gain on a deemed sale of stock (under the mark-to-market election) must be recognized, but that a loss from a deemed sale is not allowed in any tax year. Basis in the reacquired asset is its closing market price or fair market value, whichever applies, on the date of the deemed sale, whether the deemed sale results in a gain or unallowed loss. Keith Lawson Naomi Gendler Camper Senior Counsel Assistant Counsel Attachments Note: Not all recipients receive the attachments. To obtain copies of the attachments to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachments for memo 12829. ICI Members may retrieve this memo and its attachments from ICINet (<http://members.ici.org>).⁴ This January 2 valuation formula is used for "readily tradable stock," which the instructions confirm includes RIC shares. ³Attachment no. 1 (in .pdf format)