

MEMO# 12967

December 22, 2000

TAX PROVISIONS ENACTED AS PART OF YEAR-END LEGISLATION

[12967] December 22, 2000 TO: TAX MEMBERS No. 38-00 ACCOUNTING/TREASURERS COMMITTEE No. 46-00 TRANSFER AGENT ADVISORY COMMITTEE No. 66-00 RE: TAX PROVISIONS ENACTED AS PART OF YEAR-END LEGISLATION The Consolidated Appropriations Act for FY 2001, H.R. 4577 ("the FY 2001 Appropriations Act"), which was signed into law by President Clinton on December 21, 2000, includes several provisions of interest to regulated investment companies ("RICs") and their shareholders. Except as described below, the provisions discussed in this memorandum are contained in the Community Renewal Tax Relief Act of 2000, H.R. 5662 ("the Community Renewal TRA"), which was enacted as part of the FY 2001 Appropriations Act. A. Taxation of Securities Futures Contracts (New Internal Revenue Code Section 1234B) The Commodity Futures Modernization Act of 2000, H.R. 5560 ("the Commodity Futures Modernization Act"), which also was enacted as part of the FY 2001 Appropriations Act, permits the creation of a new type of securities futures contract. A "security future" generally is defined in new section 3(a)(55)(A) of the Securities Exchange Act of 1934 ("the 1934 Act"), as a contract of sale for future delivery of a single security or a narrow-based security index. A "narrow-based security index" generally is defined, in new section 3(a)(55)(B) of the 1934 Act, as an index: (1) that has nine or fewer component securities; (2) in which a component security comprises more than 30 percent of the index's weighting; (3) in which the five highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or (4) in which the lowest weighted component securities comprising an aggregate of 25 percent of the index's weighting have less than specified aggregate dollar values of average daily trading volume. Pursuant to new section 3(a)(55)(C) of the 1934 Act, however, an index will not be a narrow-based security index if any one of six conditions is met. Under one such condition, an index will not be narrow-based if a futures contract on the index is traded on, or subject to the rules of, an exchange and the contract meets the requirements jointly established by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). 2Trading in these new securities futures generally cannot begin, pursuant to the Commodity Futures Modernization Act, until after the exchanges have developed appropriate rules and, in no event, earlier than December 21, 2001 (one year after the date the FY 2001 Appropriations Act was enacted).1 General Tax Treatment. The Community Renewal TRA establishes new Internal Revenue Code section 1234B to provide the tax rules for these new securities futures contracts. Under this Act, securities futures contracts generally are not treated as section 1256 contracts that must be marked to market;2 hence, gain or loss on the sale of a securities futures contract (other than by a dealer)3 will be treated as having the same character as any gain or loss that would arise from the sale of the property to which the contract relates (rather than receiving "60/40" treatment (60 percent long-term, and 40 percent short-term,

gain or loss), as is the case with section 1256 contracts).⁴ Short Sales. The Act also treats a securities futures contract to sell property as equivalent to a short sale of the underlying property. Thus, capital gain or loss arising from the sale or exchange of a securities futures contract to sell property (i.e., the short side of a securities futures contract) generally will be short-term capital gain or loss.⁵ Likewise, in applying the short sale rules, a securities futures contract to acquire property will be treated similarly to the property itself. Thus, if a taxpayer holds a securities futures contract to acquire property and sells short property which is substantially identical to the property under the contract, the taxpayer will be treated as holding the property itself, thus triggering the holding period rules of section 1223(b).⁶ Wash Sales. The Act also clarifies that, under the wash sale rules, a contract or option to acquire or sell stock or securities shall include options and contracts that are (or may be) settled in cash or property other than the stock or security to which the contract relates. Straddles. Similarly, the Act provides that a stock offset by a securities futures contract will constitute a straddle. Holding Period. The holding period of stock acquired as delivery in satisfaction of a securities futures contract will include the period that the taxpayer held the contract. 1 Certain trading between principals may occur, if conditions set forth in the Act are met, beginning eight months after date of enactment. 2 A securities futures contract will not be treated as a commodities futures contract for purposes of the Code. 3 A securities futures contract held by a dealer will be a section 1256 contract. The Treasury Department is to determine before July 1, 2001 who is to be treated as a dealer. These new rules are intended to provide comparable tax treatment to (a) dealers in securities futures contracts and (b) dealers in equity options. 4 Any securities futures contract that is not treated as a section 1256 contract will be treated as a "security" for purposes of section 475. Consequently, traders in these instruments could elect to apply the mark-to-market rules of section 475. 5 Certain losses from a straddle will be treated as long-term pursuant to section 1092(b). 6 Under these rules, the holding period of the substantially identical property shall be considered to begin on the date the short sale is closed or the property is sold, gifted or otherwise disposed, whichever date occurs first. 3B. Narrowed Definition of Equity Options under Section 1256(g) The Community Renewal TRA, in conjunction with the Commodity Futures Modernization Act, also effectively modifies the tax treatment of certain equity index options that previously were not treated as broad-based -- and, therefore, were not taxed as section 1256 contracts -- under prior law,⁷ but that are broad-based in light of the new definition of a narrow-based security index. The effect of this change is to treat options on these equity indexes as section 1256 contracts -- beginning on December 21, 2000. The Community Renewal TRA accomplishes this change by modifying section 1256(g) to treat as an equity option -- not subject to section 1256 -- only an option (1) to buy or sell stock, or (2) the value of which is determined, directly or indirectly, by reference to (a) any stock, (b) any narrow-based security index, as defined by new section 3(a)(55)(A) of the 1934 Act, or (c) any group of stocks if the group meets the requirements for a narrow-based security index. Listed options that do not meet this revised definition of equity options will be treated by all taxpayers as nonequity options to which section 1256 applies. C. Qualified 5-Year Gains The Community Renewal TRA includes a technical correction to the qualified 5-year gain rules enacted in 1997.⁸ Under the 1997 Act, a taxpayer holding an asset (defined to include any single lot of a security)⁹ acquired prior to 2001 may elect to mark the asset to market as of the beginning of 2001 and include any mark-to-market gain in income for the taxable year that includes January 1, 2001. This election permits the taxpayer to treat the asset as acquired after 2000 so that it will qualify for the 18 percent tax rate if it is held for more than an additional 5 years. The technical correction provides, however, that this mark-to-market election "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." Thus, a RIC that

elected to mark a security lot to market as of January 2001 and sold the marked-to-market asset later in 2001 would effectively invalidate its mark-to-market election and could not include the gain otherwise arising from that election in income -- even if the sale occurred in the fund's next fiscal year and/or after the date on which the tax return for the fiscal year that includes January 1, 2001 had been filed. 7 Under prior law, an index was treated as broad-based if the CFTC was authorized to permit futures trading with respect to the index. 8 See, e.g., 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. 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 assets 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 assets acquired after December 31, 2000 (or marked to market at the beginning of 2001) and held for more than 5 years. 9 See, e.g., Institute Memorandum to Tax Members No. 37-00, Transfer Agent Advisory Committee No. 65-00 and Accounting/Treasurers Committee No. 44-00, dated December 15, 2000. 4In addition, the Act's Conference Agreement 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." Keith Lawson Senior 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 12967. ICI Members may retrieve this memo and its attachments from ICINet (<http://members.ici.org>). Attachment no. 1 (in .pdf format)

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