The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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TAX PROVISIONS IN CLINTON ADMINISTRATION'S FY 2001 BUDGET PROPOSAL

1 See, e.g., Institute Memorandum to Board of Governors No. 38-91, Tax Committee No. 14-91 (and others), dated June 4, 1991. 2 See Institute Memorandum to Accounting/Treasurers Members No. 35-93 and Tax Members No. 38-93, dated November 15, 1993. 3 See, e.g., Institute Memorandum to Tax Committee No. 25-98 and Task Force on Adviser/Distributor Tax Issues, dated July 24, 1998. [11627] February 11, 2000 TO: ACCOUNTING/TREASURERS MEMBERS No. 6-00 INTERNATIONAL MEMBERS No. 2-00 TAX MEMBERS No. 5-00 TRANSFER AGENT ADVISORY COMMITTEE No. 8-00 TASK FORCE ON ADVISER/DISTRIBUTOR TAX ISSUES RE: TAX PROVISIONS IN CLINTON ADMINISTRATION'S FY 2001 BUDGET PROPOSAL

_____ The Clinton Administration’s budget proposal for the fiscal year beginning October 1, 2000 (FY 2001) includes numerous provisions of interest to regulated investment companies (“RICs”) and their shareholders. Several of the provisions discussed below have previously been proposed by the Administration. All of the attached proposal descriptions are from the Treasury Department’s “General Explanations of the Administration’s Revenue Proposals.” A. Capitalization of Commissions by Mutual Fund Distributors (Attachment A) As we previously informed you, the Institute and the Internal Revenue Service have been discussing for almost ten years the proper tax treatment of commissions paid by mutual fund distributors in connection with the sale of B shares.1 In 1993, the IRS National Office issued guidance that permitted a fund distributor to deduct commissions paid on the sale of B shares.2 Although the National Office’s position has been confirmed on several occasions, IRS field agents have continued to raise this issue on audits of fund distributors.3 The Administration has proposed, as part of its FY 2001 budget proposal, that mutual fund distributors capitalize commissions paid on the sale of B shares and amortize those amounts over the period during which a contingent deferred sales charge would be imposed on redemptions. The proposal would be effective for commissions paid or incurred in taxable years ending after the date of enactment. The Administration does not intend that its proposal have any inference with respect to the treatment of a distributor’s commissions under current law. B. Limitation on Dividends Paid Deduction for Redemptions (Attachment B) 4 See, e.g., Institute Memorandum to Accounting/Treasurers Members No. 7-99, International Members No. 5-99, Tax Members No. 8-99, and Transfer Agent Advisory Committee No. 13-99, dated February 3, 1999. 5 Note, however, that legislation introduced in July 1998, which was drafted with the intention of implementing generally the Treasury proposal, included an Institute suggestion that income derived from foreign bonds generally

be exempt from US withholding tax, so long as foreign tax (if any) with respect to the bonds is not reduced or eliminated by a treaty with the United States. Thus, under the July 1998 bill, no limit would have been placed on the ability of US funds to invest in foreign securities, such as Euro bonds, that are free from foreign tax pursuant to foreign law. See Institute Memorandum to International Members No. 15-98 and Tax Members No. 21-98, dated July 14, 1998. 6 See, e.g., Institute Memorandum to Accounting/Treasurers Committee No. 9-99, International Committee No. 11-99, Tax Committee No. 5-99, and Transfer Agent Advisory Committee No. 22-99, dated March 24, 1999. 2 Under a new legislative proposal, the Administration would limit a RIC's ability to claim a dividends paid deduction ("DPD") for the portion of its redemption proceeds that is properly chargeable to accumulated earnings and profits. Specifically, the DPD on redemption would be available only when the redemptions represent a "net contraction of the RIC (as measured by the number of shares outstanding)." The Administration's explanation suggests that a "net contraction" would not occur if there are "near simultaneous" purchases and redemptions of RIC shares. This proposal would be effective for taxable years beginning after date of enactment. C. Withholding Tax Exemption for Certain Bond Fund Distributions (Attachment C) The Administration has again4 proposed to exempt from US withholding tax all distributions made to foreign investors in certain bond funds. The proposal would apply to mutual fund taxable years beginning after the date of enactment. Specifically, the Treasury explanation provides that all income received by a US mutual fund "that invests substantially all of its assets in US debt securities or cash" would be treated as interest exempt from US withholding tax when distributed to the fund's foreign investors. A fund would be treated as meeting this "substantially all" test "if it also invests some of its assets in foreign debt instruments that are free from foreign tax pursuant to the domestic laws of the relevant foreign countries." The Treasury explanation does not indicate what portion of a fund's assets could be invested in foreign bonds without violating the "some" standard.5 The Institute previously has supported this Administration proposal as an important first step toward eliminating all US tax incentives for foreign investors to prefer foreign funds over US funds.6 The Institute's position on the Administration proposal remains unchanged. 7 See Institute Memorandum to Tax Committee No. 22-99, dated August 13, 1999. 3 D. Translations of Foreign Withholding Tax (Attachment D) The Administration would modify the rules for translating foreign withholding tax into US dollars, effective for taxable years beginning after date of enactment. Under the proposal, all taxpayers would translate foreign withholding taxes at the spot rate on the date of payment. The Treasury Department's explanation notes that certain RICs and other taxpayers may find it impossible to comply with the current law requirement to translate foreign withholding taxes using the average exchange rate for the taxable year to which such taxes relate. E. Tax Credit Bonds (Better America Bonds, Qualified School Modernization Bonds and Qualified Zone Academy Bonds) (Attachment E) The Administration proposes that certain issuers be permitted to issue bonds the holders of which would be eligible for income tax credits. The proposal would authorize two new types of bonds (Better America Bonds ("BABs") and qualified school modernization bonds) and expand authority to issue qualified zone academy bonds. Holders of all three types of bonds would be permitted to accrue tax credits on a quarterly basis equal to one-quarter of the annual credit rate applicable to each bond (determined on the date the bond is issued) multiplied by the amount held. The credits, which would be treated as interest includable in the holder's gross income, would be allowable against alternative minimum tax, as well as regular tax, liabilities. The Treasury explanation provides that regulations would be issued "regarding the treatment of credits that flow through from a mutual fund to the holder of mutual fund shares." The proposal would be effective for bonds issued on or after January 1, 2001. F. Contributions of Appreciated Property to Swap Funds (Attachment F) The Administration's budget proposal

includes a provision introduced last year by Representative Neal to restrict the ability of investors to contribute appreciated assets on a tax-free basis to diversified investment pools commonly referred to as “swap funds.”7 First, the proposal would expand the definition of “readily-marketable securities” to include limited and preferred interests in partnerships; since the Code treats a contribution to a partnership as a taxable transfer if 80 percent or more of the partnership’s assets are readily-marketable securities, the proposal would have the effect of limiting tax-free contributions. Second, a taxpayer would be required to recognize gain upon the transfer of marketable stock or securities to a corporation or partnership if the corporation or partnership is (1) registered under the Investment Company Act of 1940 (the “1940 Act”) as an investment company, (2) not required to be registered under the 1940 Act because the interests in the fund are offered only to qualified purchasers within the meaning of the Act, or (3) marketed or sold to investors as providing a means of tax-free diversification. The proposal would be effective for transfers occurring on or after the date of enactment. Of particular importance, the proposal would except certain transfers of already-diversified pools of stock and securities; this exception would ensure that certain transfers involving RICs (such as transfers involving the formation of master-feeder fund structures) would not be affected by the proposal. A comparable exception was added, at the Institute’s request, to the legislative proposal introduced last year by Representative Neal. G. Income-Stripping Transactions (Attachment G) 8 See the Institute Memorandum cited in footnote 4, supra. 9 See the Institute Memorandum cited in footnote 6, supra. 10 This proposal was first advanced by the Administration late in 1995. See Institute Memorandum to Tax Committee No. 4- 96 and Transfer Agent Advisory Committee No. 5-96 (among others), dated January 25, 1996. 11 See, e.g., Institute Memorandum to Tax Committee No. 15-96, dated May 21, 1996, and the Institute Memorandum cited in footnote 6, supra. 4 The Administration would provide uniform rules for all types of income-stripping transactions, including those involving stock (e.g., money market fund shares) and service contracts, effective for all such transactions entered into after the date of enactment. Under the proposal, a strip of a right to receive future income from income-producing property generally would be characterized as a secured borrowing, not a separation in ownership. Thus, no rules would be required to allocate cost basis between the portion of the property transferred and the portion of the property retained. H. Mandatory Accrual of Market Discount (Attachment H) The Administration again8 has proposed to modify significantly the taxation of market discount by eliminating the option taxpayers now have to defer the inclusion of any market discount into income until the debt instrument acquired with market discount is sold. Under the Administration’s proposal, accrual basis taxpayers would be required to include market discount in income currently, i.e., as it accrues. The holder’s yield for market discount accrual purposes would be limited to the greater of (1) the original yield-to-maturity of the debt instrument plus five percentage points or (2) the applicable Federal rate (at the time the holder acquired the debt instrument) plus five percentage points. The proposal would apply to debt instruments acquired on or after the date of enactment. The Institute remains opposed this proposal because its effects -- accelerated inclusion of market discount in the RIC’s taxable income and potential over-inclusions of taxable income -- are inappropriate for a RIC’s individual investors.9 I. Increased Penalties for Failure to File Correct Information Returns (Attachment I) The Administration again10 has proposed to 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 five percent of the aggregate amount required to be reported correctly (subject, in general, to a $250,000 cap). An exception to the increased penalty would apply, however, if the aggregate amount actually reported by the taxpayer on all returns filed for that calendar year was at least 97 percent of the amount required to be reported. The proposal would be effective for returns the due date for which (without

regard to extensions) is more than 90 days after the date of enactment. The Institute previously opposed this proposal because the current penalty structure provides powerful incentives for RICs to correct promptly any error made.11 J. Straddle Rules (Attachment J) The Administration has proposed to modify and clarify the straddle rules, effective generally for straddles entered into on or after the date of enactment; some of these straddle provisions were in last 12 See the Institute Memorandum cited in footnote 4, supra. 5 year's budget proposal12 and some of them are new. First, the Administration proposes to repeal the stock exception from the definition of personal property, thereby generally treating offsetting positions with respect to actively-traded stock as a straddle. In addition, the Administration proposes that a loss recognized on one leg of a straddle generally be capitalized into the offsetting gain leg; if the offsetting leg consisted of two or more positions, the loss would be allocated first to the position that would generate the most gain, and then pro rata among the positions. The Administration further proposes that any taxpayer who physically settles an option or forward contract that is one leg of a straddle treat the settlement as a two-step transaction, by treating the option or forward contact as if it were terminated at fair market value immediately before delivery of the property. Finally, the Administration proposes to clarify that any interest and/or carrying charge on a straddle-related debt instrument is allocable to a straddle position and must be capitalized. Keith D. Lawson Senior Counsel Attachments Note: Not all recipients receive the attachment. To obtain a copy of the attachment referred to in this Memo, please call the ICI Library at (202) 326-8304, and ask for attachment number 11627. ICI Members may retrieve this Memo and its attachment from ICINet (http://members.ici.org).
