

MEMO# 1336

August 11, 1989

HOUSE WAYS AND MEANS COMMITTEE DRAFT VERSION OF REVENUE RECONCILIATION ACT OF 1989

- 1 - August 11, 1989 TO: TAX COMMITTEE NO. 12-89 RE: HOUSE WAYS AND MEANS
COMMITTEE DRAFT VERSION OF REVENUE RECONCILIATION ACT OF 1989

_____ Congress recessed last week before the House Ways and Means Committee completed its consideration of the Revenue Reconciliation Act of 1989 (the current tax bill). One significant issue presently awaiting resolution is the manner in which capital gains will be taxed (e.g., as under current law, at a reduced rate and/or indexed for inflation). During its consideration of the bill, however, the Committee did reach numerous decisions on specific provisions, including some relating to regulated investment companies (RICs). Last Friday, Committee Chairman Rostenkowski introduced a bill (H.R. 3150) containing the legislative language for all provisions adopted by the Committee before the recess. In publishing the legislative language, Chairman Rostenkowski did not intend to suggest that substantive policy decisions previously reached would be revised or reopened in the Committee. Rather, the language was released as a "courtesy ... so that necessary clarifications or technical modifications can be identified and accommodated" prior to the Committee's official reporting of the bill in September. Of course, even if no provision is changed by the Ways and Means Committee, changes could occur on the House floor, in the Senate and in the Conference Committee. Attached for your review is the legislative language released by Chairman Rostenkowski that is of interest to RICs. No Committee explanations for the provisions were released, however. Consequently, attached are Committee explanations for the provisions as originally introduced. To the extent that the bill language and the attached explanations are inconsistent, the bill language controls. Please consult the bill for proposed effective dates.

RIC-Specific Issues - 2 - The following three provisions relate specifically to RICs: (1) an amendment that would increase the Section 4982 minimum distribution requirement for ordinary income from 97 percent to 98 percent (Attachment 1); (2) an amendment to Section 852 that would prohibit shareholders who purchase shares in one RIC (RIC "A") and transfer all or part of that investment to a second RIC in the same complex (RIC "B") from including the sales charge in the basis of any RIC "A" shares disposed of before the 31st day after the date on which they were acquired if the taxpayer subsequently acquires the RIC "B" shares at a sales load that is reduced from the otherwise applicable amount because a load had previously been paid on the RIC "A" shares that were sold within 30 days of their purchase; (Attachment 2); and (3) an amendment to Section 852(b) that would require RICs to treat a dividend as received on the date the stock owned by the RIC becomes ex-dividend with respect to such dividend (Attachment 3). Phantom Income No provision regarding phantom income (Section 67(c)) is included in the bill. As we previously informed you, when Congress enacted the

Technical and Miscellaneous Revenue Act of 1988 (TAMRA) last year, it intended (per the Conference Report) to postpone imposition of the phantom income tax on publicly- offered RICs until 1990. However, the enacted TAMRA language both delayed application of Section 67(c) to publicly-offered RICs until 1990 and repealed Section 67(c) entirely for taxable years beginning after 1989. (See Institute Memorandum to Tax Members No. 59-88, Closed-End Fund Members No. 55-88, Unit Investment Trust Members No. 69-88 and Accounting/Treasurer Advisory Committee No. 41-88, dated November 14, 1988). This year, during its deliberation of the tax bill, the House Ways and Means Committee determined that the repeal of Section 67(c) enacted in 1988 should be permitted to go into effect at the end of 1989 without modification. Consequently, no special provision regarding phantom income was necessary. Of course, the Ways and Means Committee determination could be reversed later in the legislative process.

Other Relevant Provisions Other provisions of interest to RICs include: (1) a new Section 386 that would treat as preferred stock any "disqualified" discount obligation (i.e., any debt instrument (i) with a maturity date of more than 5 years from the date of issue, (ii) with a yield to maturity equaling or exceeding the - 3 - sum of the applicable Federal rate under Section 1274(d) for the calendar month in which the obligation is issued plus 5 percentage points, and (iii) which has "significant original issue discount"). This provision is intended to generally change the tax status of payment-in-kind (PIK) bonds. (Attachment 4); (2) an amendment to Section 1059 that would treat as an extraordinary dividend any dividend with respect to "disqualified preferred stock" (i.e, a stock which (i) when issued, has a dividend rate which declines (or can reasonably be expected to decline) in the future, (ii) has an issue price exceeding its liquidation rights or its stated redemption price, or (iii) is otherwise structured to avoid the other provisions of Section 1059 and to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock) (Attachment 5); (3) an amendment that would clarify the Treasury Department's regulatory authority under Section 385 to treat an instrument as part stock and part debt (Attachment 6); and (4) an amendment to Section 1503 that would require any distribution made by a member of a group of corporations filing a consolidated return to a nonmember shareholder (such as a RIC) to be treated as a dividend only to the extent that the consolidated group as a whole, and not the corporation paying the dividend, has earnings and profits (Attachment 7).

Civil Penalties Provisions The bill also includes the modifications to the information reporting penalty system previously approved by the House Ways and Means Committee. (See Institute Memorandum to Closed-End Fund Committee No. 23-89, Unit Investment Trust Committee No. 32- 89, Transfer Agent Shareholder Advisory Committee No. 14-89, Operations Members No. 18-89 and Tax Members No. 21-89, dated July 6, 1989 and accompanying attachments.)

Action Requested Please review the attachments carefully and let me know no later than August 25, 1989 of any "necessary clarifications or - 4 - technical modifications" that should be submitted to the Ways and Means Committee staff prior to final consideration of the bill in September. Other comments are also welcome. We will keep you informed of developments regarding this legislation.

Keith D. Lawson Assistant General Counsel Attachments