INVESTMENT COMPANY INSTITUTE

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CONGRESS APPROVES REVENUE RECONCILIATION ACT OF 1995

1 A separate memorandum to Pension Members, Operations Committee and Transfer Agent Advisory Committee describes various pension-related tax provisions, including those relating to individual retirement accounts. November 21, 1995 TO: ACCOUNTING/TREASURERS MEMBERS No. 54-95 CLOSED-END FUND COMMITTEE No. 57-95 INTERNATIONAL COMMITTEE No. 38-95 OPERATIONS COMMITTEE No. 34-95 TAX MEMBERS No. 52-95 TRANSFER AGENT ADVISORY COMMITTEE No. 60-95 UNIT INVESTMENT TRUST COMMITTEE No. 82-95 RE: CONGRESS APPROVES REVENUE RECONCILIATION ACT OF 1995 ____ The "Balanced Budget Act of 1995" approved this week by Congress includes several tax provisions, contained in the "Revenue Reconciliation Act of 1995" ("the Act"), that are of interest to regulated investment companies ("RICs"), certain other investment pools and their shareholders/investors. President Clinton is expected to veto this legislation. Negotiations between Congress and the President on budget and tax issues are expected to follow.1 I. Mutual Fund Tax Simplification (Attachments 1A and 1B) A. Repeal of the 30 Percent Test The Act would repeal the 30 percent test of Internal Revenue Code ("Code") section 851(b)(3) for taxable years ending after date of enactment. B. Tax-Free Conversions of Bank Common Trust Funds into RICs The Act would permit a bank common trust fund meeting a modified diversification standard to transfer substantially all of its assets to one or more RICs in a tax-free exchange. The common trust fund would be required to transfer its assets to the RIC(s) solely in exchange for shares of the RIC(s) and the common trust fund then would be required to distribute the RIC shares to its participants in exchange for the participants interests in the fund. The proposal would be effective for transfers after December 31, 1995. 2 A RIC would be treated as owning its proportionate share of the assets of any partnership in which it invests. A separate "at risk" rule would provide that an asset (such as a RIC's portfolio asset) would not be treated as an indexed asset for any period during which a taxpayer's risk of loss on the asset had been substantially reduced. - 2 - II. Capital Gains Provisions (Attachments 2A through 2D) A. 50 Percent Capital Gains Deduction for Individuals Individuals would be permitted under the Act generally to deduct from income 50 percent of their net long-term capital gains (i.e., on assets held for more than one year). This provision would apply to dispositions on or after January 1, 1995. Gains realized by a RIC and distributed to its shareholders would be eligible for the 50 percent deduction based upon the date each asset was sold by the RIC, rather than upon the date the distribution was made to shareholders. B. Maximum Capital Gains Rate for Corporate Shareholders Under the Act, the maximum tax rate on capital gains realized by a corporation would be 28 percent. This provision would apply to dispositions on or after January 1, 1995. C. Indexing Cost Basis for Inflation The Act also would permit individuals, for purposes of calculating gain (but not loss), to increase or "index" for inflation the cost

basis of certain assets acquired after December 31, 2000 and held for more than three years. For example, if an eligible asset were purchased on January 1, 2001 for $100 and held for 10 years, during which time inflation totaled 40 percent, the indexed basis of the asset would be $140. If the asset were sold at the end of 10 years for $200, the indexed gain would be $60 ($200 - $140), rather than $100 ($200-$100), as under present law. Similarly, under the "indexing cannot create a loss" rule, if the asset were sold for between $100 and $140, the taxpayer would report neither gain nor loss. Under the Act, RICs would be permitted to index the cost basis of their indexing-eligible assets (e.g., common stock, generally, but not debt). Eligible RIC shareholders would index the cost basis of their RIC shares to the extent that the underlying RIC portfolio consisted of indexing-eligible assets.2 Specifically, RIC shares would be treated as an "indexed asset" eligible for indexing for any calendar quarter in the same ratio as the average value of the RIC's indexed assets at the close of each month in the quarter bears to the average value of all of the RIC's assets at the close of such months (the "indexed asset calculation"). Adopting an Institute suggestion, a "safe harbor" would treat RIC shares as eligible for (i) 100 percent of any indexing adjustment for a particular quarter if at least 80 percent of the RIC's assets (on average) were invested in indexed assets on the last day of each month in the quarter and (ii) no inflation adjustment for that quarter if 20 percent or less of the RIC's assets (on average) were invested in indexed assets on the last day of each month in the quarter. 3 Mark-to-market losses, however, could never be used to reduce a taxpayer's tax liability. - 3 - A special mark-to-market transition rule would permit individuals who acquired assets such as RIC shares before 2001 to index them for inflation occurring after 2000 if they (i) marked them to market using January 1, 2001 values, (ii) included in income during 2001 any resulting mark-to-market gain3 and (iii) held the assets for at least three more years. This election would be made on an asset-by-asset basis. One significant effect of the Act's limitation of indexing benefits to individual shareholders would be to cause RICs with both corporate and individual shareholders to report different amounts of taxable income to each group, even though they would receive the same distributions. Under the Act, RICs would be required to distribute to shareholders only the amount of gain that would be taxable to individual shareholders after application of the indexing adjustment. For example, if a RIC realized a $100 gain, $40 of which was attributable to inflation, the RIC would be required to distribute only $60 to shareholders. However, because corporate shareholders would not be entitled to the benefits of indexing, RICs would have to report as dividends to these shareholders their allocable share of both the amount distributed ($60) and the amount retained ($40), all of which would be taxable to these corporate shareholders. D. Maximum Tax Rate on Qualified Small Business Stock Under the Act, the maximum tax rate on gains attributable to "qualified small business stock" held by individuals would be 14 percent. The present law definition of "qualified small business stock" would be modified to include stock purchased at original issuance, at which time the corporations assets did not exceed $100 million (rather than $50 million), and held for at least 5 years. The provision imposing a 14 percent maximum tax rate would apply to taxable years beginning after date of enactment. The amendment increasing the corporate capitalization limit from $50 million to $100 million would apply to stock issued after date of enactment. III. Passive Foreign Investment Companies ("PFICs") (Attachment 3) The Act would modify the passive foreign investment company ("PFIC") rules to provide every taxpayer that holds "marketable" PFIC stock with an election to mark that stock to market at the close of the taxpayers taxable year. The provision would be effective for taxable years of U.S. persons beginning after December 31, 1995, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. All PFIC stock held by open-end RICs (and by closed-end RICs, except as provided by regulation) would be treated as marketable stock. Once a taxpayer made a mark-to-market election with respect to a stock, the election would apply to that stock for all subsequent years, unless the IRS consented to a revocation of the election. Unlike versions of this provision introduced in prior years, RICs would mark their PFICs to market only at fiscal-year-end, and - 4 - not also at October 31 for purposes of the excise tax minimum distribution requirements of Code section 4982. Under the Act, any PFIC mark-to-market gain would be treated as ordinary income. PFIC mark-to-market losses would be allowable as an ordinary loss to the extent of net mark- to-market gains previously included with respect to such stock. The Act also would provide that the nondeductible "interest charge" that would otherwise be imposed on a RIC that held PFIC stock prior to the effective date of the Act would not be imposed if the RIC had elected mark-to-market treatment (presumably under proposed regulations previously issued by IRS) for the prior taxable year. IV. Financial Asset Securitization Investment Trusts ("FASITs") (Attachment 4) The Act would create a new type of entity, called a financial asset securitization investment trust ("FASIT"), for the securitization of certain debt obligations such as credit card receivables, home equity loans and auto loans. Interests in a FASIT would be limited to (i) a single "ownership interest," which could be held only by a single taxable domestic corporation (which would preclude RICs from holding ownership interests), and (ii) "regular interests," which could be held by the general public (including RICs) and would be treated generally as debt obligations of the FASIT. This FASIT provision would be effective on date of enactment. An entity could not qualify as a FASIT unless, among other things, it (i) elected FASIT status (which could not be elected if the entity registered under the Investment Company Act of 1940), (ii) limited substantially all of its assets to "permitted assets" (such as certain debt instruments) and (iii) limited its investment activities (including the disposition of assets) in certain ways. In addition, if a FASIT were to issue "regular interests" that yielded interest in excess of a prescribed rate, these "regular interests" would be deemed "high-yield interests" that could be held generally only by those corporations eligible to hold ownership interests (e.g., not RICs). A FASIT generally would not be taxable. Instead, the FASIT’s taxable income or net loss would flow through to its owner and would be taxed, in many ways, as if the FASIT owner were a partner in a partnership (although certain significant differences would arise). Holders of FASIT regular interests generally would be taxed like holders of any other debt instrument, except that they would be required to take interest income into account under the accrual method of accounting. In addition, holders of high-yield interests could not use net operating losses to offset any income derived from the high-yield interests. V. Common Investment Funds for Certain Foundations (Attachment 5) The Act would amend the tax-exempt organization rules of Code section 501 to generally treat an organization comprised solely of at least 20 tax-exempt private foundations and/or community foundations as tax-exempt itself, so long as the organization is organized and operated solely to collectively invest in stocks and securities on behalf of its members. The provision would be effective for taxable years ending after December 31, 1995. - 5 - VI. Provisions NOT Included in the Act Among the provisions that were included in either the House-passed or the Senate-passed bills that are not included in the Act are provisions that would have (i) simplified the reporting of foreign tax credits, (ii) required tax information statements to include the name, address and telephone number of the payors "information contact," (iii) permitted the recovery of civil damages from parties who "willfully" file "fraudulent" information returns, (iv) taxed the capital gains of certain nonresident alien investors and (v) limited the amount of deductible employee compensation to $ 1 million. * * * * * * * * * * * * * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachments Note: Not all recipients of this memo will receive the attachments. If you wish to obtain a copy of the attachments referred to in this memo, please call the Institute’s Information Resource Center at (202)326-8305 or (202)326-5903, and ask for this memo’s attachment number: 7429.