

MEMO# 11154

August 3, 1999

SENATE APPROVES TAX LEGISLATION

1 The relevant pension-related provisions in the bill are summarized in a separate Institute Memorandum. 2 See Institute Memorandum to Accounting/Treasurers Members No. 19-99, Closed-End Investment Company Members No. 27-99, Operations Members No. 18-99, Tax Members No. 21-99, Transfer Agent Advisory Committee No. 46-99 and Unit Investment Trust Members No. 16-99, dated July 27, 1999. [11154] August 3, 1999 TO: ACCOUNTING/TREASURERS MEMBERS No. 20-99 CLOSED-END INVESTMENT COMPANY MEMBERS No. 29-99 OPERATIONS MEMBERS No. 19-99 TAX MEMBERS No. 24-99 TRANSFER AGENT ADVISORY COMMITTEE No. 49-99 UNIT INVESTMENT TRUST MEMBERS No. 17-99 RE: SENATE APPROVES TAX LEGISLATION

The Senate has approved S. 1429, the "Taxpayer Refund Act of 1999" (hereinafter "the bill"). This memorandum discusses the following attached provisions of interest to regulated investment companies ("RICs") and their shareholders:¹ (1) the treatment of distributions of accumulated earnings and profits from a "non-RIC" year; (2) the treatment of gain from constructive ownership transactions, including certain "synthetic" investments in RICs; and (3) proposed revisions affecting the taxation of capital gains, including an annual \$1,000 deduction for net capital gains of individuals. Note, however, that the bill contains the attached "sunset" provision (Attachment D) designed to comply with procedures under the Congressional Budget Act of 1974 by which Congress implements spending and tax policies contained in a budget resolution. Specifically, the bill provides that all of its provisions and amendments that are in effect on September 30, 2009 will cease to apply as of that date. As with the House-passed tax legislation,² President Clinton has indicated that he would veto the bill if it were presented to him in its current form because of the magnitude of the bill's tax cut provisions.

Distribution of Accumulated Earnings and Profits from a Non-RIC Year (Attachment A) The bill would make three modifications to the provisions of Subchapter M that impact certain RICs with accumulated earnings and profits from "non-RIC" years. A RIC may acquire such earnings and profits through either a conversion from non-RIC to RIC status or a merger with a non-RIC. First, the bill would amend section 852(c) to provide that any distribution made to satisfy the requirement that the RIC have no non-RIC earnings and profits as of the end of the taxable year "shall be treated . . . as made from the earliest earnings and profits accumulated in any taxable year to which the provisions of this part did not apply." This would represent a change from current law under which distributions from earnings and profits essentially are treated as being made on a last in, first out basis. Second, the bill would provide that a distribution treated as being made from accumulated earnings and profits shall not be treated as a distribution for purposes of calculating the dividends paid deduction under section 852(b)(2)(D) or the "spillover" dividend rules of section 855. This change expressly would permit a RIC to use a spillover dividend to distribute its taxable income for a year in which it acquires non-RIC earnings and profits that it must distribute. Third, the bill would expand the "deficiency

dividend” relief provided by section 852(e) where a failure to qualify under Subchapter M is attributable solely to a failure to distribute non-RIC earnings and profits. Under the provision, a deficiency-type distribution of non-RIC earnings and profits would permit the RIC to qualify in the initial year to which a failed determination under Subchapter M applied, in addition to subsequent years (before the deficiency-type distribution is made). These provisions would apply to distributions after December 31, 2000.

Treatment of Gain from Constructive Ownership Transactions (Attachment B) The bill would prevent the conversion of ordinary income or short-term capital gain into income eligible for long-term capital gain treatment with respect to certain “constructive ownership transactions” involving, among other things, an equity interest in a pass-thru entity (that would be defined to include a RIC). Under proposed new section 1260, a taxpayer generally would be treated as having entered into a constructive ownership transaction with respect to a pass-thru entity if the taxpayer: (1) holds a long position under a swap contract with respect to the entity; (2) enters into a forward or futures contract to acquire the entity; (3) is the holder of a call option, and is the grantor of a put option, with respect to the entity and the such options have substantially equal strike prices and substantially contemporaneous maturity dates; or (4) enters into one or more other transactions (or acquires one or more positions) that have substantially the same effect as a transaction described above. More specifically, the bill would (1) limit the amount of long-term gain to the long-term gain, if any, that the taxpayer would have received had an investment been made directly in the underlying pass- thru entity (an amount termed the “net underlying long-term capital gain”) and (2) impose an interest charge on any deferred short-term gain. An exception to this treatment would be provided if all of the positions that are part of the transaction are marked to market. Under the bill’s effective date, the constructive ownership provisions would apply to transactions entered into after July 11, 1999. For this purpose, a contract, option or any other arrangement that is entered into or exercised on or after July 12, 1999 which extends or otherwise modifies the terms of a transaction entered into prior to such date is treated as a transaction entered into on or after July 12, 1999.

Capital Gains Provisions (Attachment C)

A. Annual Deduction for the First \$1,000 of Net Capital Gains Earned by Individuals In proposed new section 1202, the bill would allow an individual to deduct the first \$1,000 of net capital gain for each taxable year. For this purpose, net capital gain would not include gain from related-party sales or exchanges. The deduction generally would not be available to (1) dependents claimed as an exemption on another taxpayer’s return; (2) a married individual filing a separate return for the taxable year; or (3) an estate or trust. In applying the provision to RICs and other pass-thru entities, the determination of when a sale or exchange occurs would be made at the entity level. The deduction for capital gains generally would apply to taxable years beginning after December 31, 2005.

B. Treatment of Collectibles Gain (or Loss) as Short-Term The bill would treat any gain (or loss) from the sale of a collectible (such as gold bullion) as short-term capital gain (or loss), without regard to the collectible’s actual holding period. Under the bill, any gain from the sale or exchange of an interest in a partnership, S corporation or trust that is attributable to unrealized appreciation in the value of collectibles held by such entity would be treated as collectibles gain. This provision effectively would eliminate application of the 28 percent rate to collectibles gain. The provision would apply to sales and exchanges of collectibles after December 31, 2005.

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