

MEMO# 10334

September 28, 1998

HOUSE APPROVES CAPITAL GAINS TECHNICAL CORRECTION

1 See Institute Memorandum to Tax Members No. 29-98, Accounting/Treasurers Members No. 23-98, Closed- End Investment Company Members No. 27-98, Unit Investment Trust Members No. 20-98, Operations Members No. 23-98 and Transfer Agent Advisory Committee No. 58-98, dated September 21, 1998. 2 See Institute Memorandum to Tax Members No. 18-98, Accounting/Treasurers Members No. 16-98, Operations Members No. 17-98, Closed-End Investment Company Members No. 19-98, Unit Investment Trust Members No. 14-98, International Members No. 13-98, Transfer Agent Advisory Committee No. 33-98 and Broker/Dealer Advisory Committee No. 10-98, dated June 26, 1998. 3 See Institute Memorandum to Tax Members No. 27-97, Accounting/Treasurers Members No. 31-97, Operations Members No. 13-97, International Members No. 12-97, Closed-End Investment Company Members No. 23-97, Unit Investment Trust Members No. 28-97 and Transfer Agent Advisory Committee No. 36-97, dated August 1, 1997. [10334] September 28, 1998 TO: TAX MEMBERS No. 31-98 ACCOUNTING/TREASURERS MEMBERS No. 25-98 CLOSED-END INVESTMENT COMPANY MEMBERS No. 30-98 UNIT INVESTMENT TRUST MEMBERS No. 23-98 OPERATIONS MEMBERS No. 25-98 TRANSFER AGENT ADVISORY COMMITTEE No. 60-98 RE: HOUSE APPROVES CAPITAL GAINS TECHNICAL CORRECTION

The House of Representatives has approved H.R. 4579, the "Taxpayer Relief Act of 1998" (hereinafter "the House bill"), by a vote of 229-195. As we previously informed you,¹ the House bill would modify the capital gains holding period change that was enacted earlier this year as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "1998 Act")² and make certain other changes of interest to regulated investment companies ("RICs") and their shareholders. While President Clinton has indicated that he will veto the House bill (in its current form), the Treasury Department does not object to treating the capital gains provision discussed below as a "technical correction." Background The 1998 Act modified the taxation of capital gains by reducing from 18 months to one year the holding period requirement for the 20-percent maximum capital gains rate that was enacted as part of the Taxpayer Relief Act of 1997 ("the 1997 Act").³ The 1998 Act's change applies to amounts "properly taken into account" after December 31, 1997. Under the 1998 Act, any gain on the disposition after 1997 of RIC shares held for more than one year is taxed at a 20 percent maximum rate. However, under the 1998 Act, any portion of a RIC capital gain dividend paid during 1998 that is attributable to long- 4 Some RICs may have "collectibles gain" that remains taxable at a 28 percent maximum rate and/or "unrecaptured section 1250 gain" that remains taxable at a 25 percent maximum rate. term gain on RIC assets sold during 1997 (but not held by the RIC for more than 18 months) would remain taxable at a 28 percent maximum rate. Technical Correction The effective date for the 1998 Act's capital gains change would be modified by a "technical correction"

in the House bill so that, in essentially all instances, RIC capital gain dividends paid to shareholders during 1998 would be taxed at a maximum rate of 20 percent.⁴ This technical correction would apply as if included in the 1998 Act. We are pleased to inform you that the statutory language passed by the House includes a provision clarifying the extension of this technical correction to gains recognized by RICs from “qualifying partnerships,” which is defined to include investments by RICs in “master funds” in the master-feeder fund structure. Thus, for example, gain on an asset sold on November 15, 1997 by a qualified partnership master fund, after being held by the master fund for 15 months, would be eligible for 20-percent rate treatment if distributed by a feeder fund RIC to its shareholders after December 31, 1997. Under the House bill, a partnership is a “qualified partnership” with respect to a RIC if: (1) the partnership is an investment company registered under the Investment Company Act of 1940 (the “1940 Act”); (2) the RIC is permitted to invest in such partnership by reason of section 12(d)(1)(E) of the 1940 Act or an SEC exemptive order under such section; and (3) the RIC and the partnership have the same taxable year. Other requirements that must be met for the technical correction to apply to gains from a partnership include requirements that: (1) as of January 1, 1998, either: (a) at least 35 percent of the RIC’s total assets are in one qualified partnership; or (b) at least 90 percent of the RIC’s total assets are invested in more than one qualified partnership; (2) the partnership recomputes its gains and losses applying the technical correction; and (3) the partnership provides the RIC with written documentation of its distributive share as so redetermined. Keith D. Lawson Senior Counsel Attachment Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute's Library Services Division at (202)326- 8304, and ask for this memo's attachment number: 10334.