

**MEMO# 2897**

July 1, 1991

# **TAX SIMPLIFICATION LEGISLATION INTRODUCED**

July 1, 1991 TO: TAX MEMBERS NO. 23-91 CLOSED-END FUND MEMBERS NO. 27-91  
INTERNATIONAL COMMITTEE NO. 11-91 ACCOUNTING/TREASURERS COMMITTEE NO. 16-91  
RE: TAX SIMPLIFICATION LEGISLATION INTRODUCED

The "Tax Simplification Act of 1991" has been introduced in the House and Senate. The bill, identified in the House as H.R. 2777, addresses two issues of concern to regulated investment companies ("RICs"): the taxation of stock in passive foreign investment companies ("PFICs") and simplification of the rules concerning the limitation on foreign tax credits applicable to individual investors. The bill creates a new definition, the passive foreign corporation or "PFC", which replaces, among other definitions, the definition of a PFIC. A PFC is any foreign corporation if (1) 60 percent or more of its gross income is passive income (compared to a 75 percent requirement under the current PFIC definition), (2) 50 percent or more of its assets by value (measured on average over the year) produce or are held for the production of passive income, or (3) it is registered under the Investment Company Act of 1940 as either a management company or a unit investment trust. Under a new election, PFCs which meet certain requirements can elect to be treated as foreign corporations. PFIC Provisions The bill adds a mark-to-market system of taxation for PFICs to the two existing tax regimes for PFICs, current inclusion under the qualified electing fund or "QEF" rules and the deferred interest charge method. As proposed, QEF rules will be available to any U.S. person owning less than 25 percent of the stock of a PFC that is not U.S. controlled (U.S. control is generally defined as five or fewer U.S. persons owning more than 50 percent of the PFC stock). Shareholders not electing QEF treatment are subject to one of two methods for taxing the economic equivalent of the PFC's current income. Under the bill, the mark-to-market system will - 1 - be mandatory for all taxpayers holding marketable PFC stock. For these purposes, all PFCs held by open-end registered investment companies will be considered marketable, as will such stock held by a closed-end fund, unless the Internal Revenue Service promulgates regulations which disallow such treatment for closed-end funds. Gains on PFIC stock will be recognized in full as ordinary gain. Mark-to-market losses will be ordinary to the extent of prior net gains, referred to in the bill as "unreversed inclusions". Mark-to-market losses in excess of unreversed inclusions will be suspended (i.e., no basis adjustment is made in that year and no loss is recognized). In addition, upon actual disposition, losses will be treated as ordinary to the extent of unreversed inclusions. However, losses in excess of unreversed inclusions will be treated as capital losses upon disposition. Under special RIC rules, mark-to-market gain is treated as a dividend for purposes of the 90 percent test of Internal Revenue Code section 851(b)(2) and the 30 percent limitation of section 851(b)(3). Foreign Tax Credit Provisions Consistent with the Institute's prior requests, the bill would also allow individuals with no more than \$200 of

foreign taxes which can be claimed as a credit and with no foreign source income other than passive income (i.e., dividends, interest, etc.) to elect a simplified foreign tax credit limitation equal to the lesser of the actual foreign taxes paid or 25 percent of the individual's foreign source income. (See Institute Memorandum to Tax Committee No. 2-91, dated January 30, 1991.) The explanation to the bill specifically states that a Form 1116, the individual foreign tax credit reporting form, should not be required. The simplified limitation will only be available to persons who receive a payee statement, such as a Form 1099, with the amount of the foreign taxes reported on the form. Both provisions of the bill are generally effective for taxable years of U.S. persons beginning after December 31, 1991. The pertinent sections of the bill and explanation are attached. We will keep you informed of further developments. David J. Mangefrida, Jr. Assistant Counsel - Tax Attachment

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