

**MEMO# 1149**

May 10, 1989

# **INSTITUTE STATEMENT ON CAPITAL GAIN PROPOSALS**

- 1 - May 10, 1989 TO: TAX COMMITTEE NO. 6-89 ACCOUNTING/TREASURERS COMMITTEE NO. 20-89 CLOSED-END FUND COMMITTEE NO. 15-89 RE: INSTITUTE STATEMENT ON CAPITAL GAIN PROPOSALS

Attached is the Institute's statement to the House Ways and Means Committee concerning the President's capital gain proposal. The statement addresses special problems that would be created for regulated investment companies (RICs) and their shareholders should Congress enact without modification either (1) the President's proposal to lower to 15 percent the maximum capital gain tax rate on qualified assets held by individuals for the long-term capital gain holding period, which would be lengthened to two years in 1993 and to three years in 1995, (2) any proposal to provide three or more (multiple tier) holding periods for capital assets, or (3) any proposal to index the basis of certain capital assets.

1. The President's Proposal The President's proposal contemplates that a RIC's individual shareholders will be entitled to the 15 percent capital gains tax rate on long-term capital gains realized by the RIC and flowed through to its shareholders. One problem created by the President's proposal for RIC shareholders compared to direct investors is that lengthening the holding period for long-term capital gain treatment would further diminish the ability of RIC shareholders to offset unrelated capital losses against capital gains realized by the RIC. Whereas under current law only capital gains realized on assets held by the RIC for one year or less are treated as short-term and denied flow through treatment to RIC shareholders, the President's proposal would treat as short-term capital gains those gains realized during the first three years that an asset is held by the RIC and would, consequently, deny RIC shareholders the opportunity they presently have to offset unrelated capital losses from assets - 2 - held for between one and three years against capital gains realized on assets held by the RIC for between one and three years. For this reason, the Institute believes that if the President's proposal is enacted, RICs should be permitted to flow through to their shareholders gains which may be designated in accordance with the holding period from which they are derived.

2. Multiple Tier Capital Gain Proposals Similarly, because RICs are currently able to flow through to shareholders only those capital gains realized from one holding period category (the long-term category), proposals to increase the number of capital gain holding periods from two to three or more would disadvantage RIC shareholders compared to direct investors unless, as the Institute has recommended, RICs are permitted to flow through to their shareholders gains which may be designated in accordance with the holding period category (be it long-term, middle-term, or short-term) from which they are derived. The statement also notes that multiple tier capital gain holding period proposals would create the need for "stacking rules" to net losses from one holding period category against gains from another category. Illustrations are given regarding how these stacking rules could be developed.

3. Indexing Proposals The

indexing proposals currently before Congress would provide generally for indexing the basis of corporate stock, but not of debt obligations. Two types of indexing would apply to RICs and their shareholders. First, the RIC itself would index certain assets in its portfolio. Second, RIC shareholders would index the basis of their RIC stock, which would be treated as an "indexed asset," i.e., an asset eligible for indexing, for any calendar month in the same ratio as the RIC's assets at month-end which are indexed assets bears to the value of all of the RIC's assets at month-end (the "indexed asset calculation"). This second type of indexing, while critical to the fairness of any indexing proposal, would require detailed recordkeeping and burdensome computations. The Institute's statement describes in detail the complex computations that would be required under the indexing proposals to determine the extent to which RIC stock would be treated as an "indexed asset" eligible for indexing. In general, these computations would be necessary unless a RIC were invested almost exclusively in either corporate stock, in which case the RIC stock would be treated as a fully (100 percent) indexed asset, or in debt obligations, in which case the RIC stock would not be treated as an indexed asset. The statement suggests modifying the manner in which RIC stock is determined to be an indexed asset to limit the computations that would be required. Specifically, the Institute has proposed that (1) determinations - 3 - of the extent to which RIC stock is to be treated as an indexed asset would be made quarterly rather than monthly and (2) the safe harbor provision: (a) treat the ratio of indexed assets to all assets as being 100 percent if 80 percent or more of the RIC's portfolio is in indexed assets, (b) treat the ratio as being 50 percent if between 20 and 80 percent of the RIC's portfolio is in indexed assets, and (c) treat the ratio as being zero if 20 percent or less of the RIC's portfolio is in indexed assets. We will keep you informed of developments. Keith D. Lawson Assistant General Counsel Attachment