

MEMO# 1549

November 21, 1989

INSTITUTE COMMENTS ON APPLICATION OF REGULATIONS UNDER SECTIONS 382 AND 383 TO MUTUAL FUNDS

November 21, 1989 TO: TAX MEMBERS NO. 44-89 ACCOUNTING/TREASURERS COMMITTEE
NO. 49-89 RE: INSTITUTE COMMENTS ON APPLICATION OF REGULATIONS UNDER SECTIONS
382 AND 383 TO MUTUAL FUNDS

As you may know, concerns have arisen that temporary regulations issued by the IRS pursuant to Code sections 382 and 383 may be applied to the issuance and redemption of mutual fund shares in the ordinary course of business. (See Institute Memorandum to Tax Members No. 41-89 and Closed-End Fund Members No. 59-89, dated October 20, 1989). First, the so-called "segregation rules" could be applied to treat all shares issued on any day as being owned by a separate "5-percent shareholder," which could ultimately limit a fund's ability to utilize capital loss carryforwards and net unrealized built-in losses. Second, the value of the fund could be reduced by the value of fund shares issued and redeemed in the ordinary course of business for purposes of computing the so-called "section 382 limitation," which could further limit a fund's ability to utilize capital loss carryforwards and net unrealized built-in losses. The attached Institute letter to Treasury and the Internal Revenue Service (1) describes the effect of applying these rules to the continuous issuance and redemption of mutual fund shares, (2) discusses how the issuance and redemption of mutual fund shares is essentially equivalent to the exchange trading of other securities (which are exempted from the rules at issue), (3) reviews the legislative history of these provisions and argues that applying these rules to the issuance and redemption of mutual fund shares is inconsistent with Congressional intent, (4) explains how, in other contexts, the issuance and redemption of mutual fund shares has been treated as eligible for certain preferential treatment provided for the exchange trading of other securities, and (5) urges that the regulations under sections 382 and 383 be modified to make clear that neither the segregation rules nor the valuation rules will apply to the issuance and redemption of mutual fund shares in the ordinary course of business. We will keep you informed of developments. Keith D. Lawson Assistant General Counsel Attachment