The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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TAX PROPOSALS IN PRESIDENT CLINTON'S BUDGET PROPOSAL

1 See Institute Memorandum to Closed-End Fund Committee No. 7-96, Operations Members No. 12-96, Pension Members No. 15-96, Tax Members No. 13-96, Transfer Agent Advisory Committee No. 15-96, and Unit Investment Trust Committee No. 10-96, dated March 26, 1996. - 1 - February 12, 1997 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 3-97 OPERATIONS MEMBERS No. 6-97 PENSION MEMBERS No. 7-97 PENSION OPERATIONS ADVISORY COMMITTEE No. 4-97 TAX MEMBERS No. 7-97 TRANSFER AGENT ADVISORY COMMITTEE No. 8-97 UNIT INVESTMENT TRUST COMMITTEE No. 9-97 ACCOUNTING/TREASURERS MEMBERS No. 7-97 RE: TAX PROPOSALS IN PRESIDENT CLINTON'S BUDGET PROPOSAL ____ President Clinton's budget proposal for the fiscal year beginning October 1, 1997 includes several tax and pension provisions of interest to regulated investment companies ("RICs") and their shareholders. Most of these provisions were included in prior Clinton Administration proposals.1 At this time, it is unclear whether the budget negotiations will produce an agreement and, if so, which Administration proposals would be included the agreement. This memorandum summarizes a number of the tax provisions in President Clinton's budget proposal. 1. Requirement To Compute Cost Basis Using The Average Cost Method (Attachment A) The proposal generally would eliminate the present-law option that sellers of securities (including stocks, debt instruments, options, certain futures contracts, and certain other derivative financial instruments) have to compute cost basis using either the specific-identification or the first-in-first-out ("FIFO") method. Instead, all securities sellers -- including RICs and their shareholders -- would be required to compute cost basis using the single-category average cost method that is available today, as an option, only to mutual fund investors. The average cost basis rules generally would not apply to contractual financial products, such as over-the-counter options, notional principal contracts or forward contracts. No obligation would be placed on brokers or other persons (including RICs) effecting securities sales (e.g., share redemptions) to calculate and/or report the average cost basis of securities sold. Under the single-category average cost method, an investor would add together the cost bases of all "substantially identical" securities and divide that number by the number of securities held to determine the average cost basis. For example, if an investor purchased 50 shares of XYZ stock at $10 per share and later purchased 50 shares at $20 per share, the average cost basis of the shares would be $15. The holding period for securities sold would be determined on a FIFO basis. The change is proposed to be effective for all securities sales (regardless of the date on which the securities were purchased) that occur after the 30th day following the date the provision is enacted. 2. "Short Against The Box" Proposal (Attachment B) 2 All section references are to the Internal Revenue Code, unless otherwise noted. - 2 - The proposal would require a taxpayer holding

an appreciated position in either stock, a debt instrument or a partnership interest to recognize gain, but not loss, upon entering into a "constructive sale" of the position. For these purposes, a constructive sale would be deemed to occur when a taxpayer holding an appreciated position (1) enters into one or more positions with respect to the same or substantially identical property which substantially eliminates both risk of loss and opportunity for gain on the appreciated position, or (2) enters into a transaction which is marketed or sold as substantially eliminating the risk of loss and opportunity for gain. The proposal would apply, among other things, to situations where a taxpayer holding appreciated stock: (1) sells the stock short ("short against the box"); (2) enters into an equity swap with respect to the stock; or (3) grants a call option or enters into a put option on the stock if there is a substantial certainty that the option will be exercised. The proposal would not apply, however, to certain transactions involving property that is not "marketable," to transactions subject to the securities dealer mark-to-market rules of section 4752 or to transactions subject to the mark-to-market rules of section 1256. A taxpayer holding property subject to the proposed constructive sale rule would be treated as having sold and immediately repurchased the appreciated property and would receive a new basis and holding period in the property. If a taxpayer entered into a constructive sale with respect to less than all of his or her appreciated positions in the property, gain would be triggered by treating the property first acquired as the first sold. This proposal would be effective for constructive sales entered into after the proposal’s date of enactment. In addition, if a constructive sale were entered into after January 12, 1996 and before date of enactment, and not closed before 30 days after date of enactment, a constructive sale would be deemed to occur on the date that was 30 days after date of enactment. 3. Extend Pro Rata Disallowance of Tax-Exempt Interest Expense to All Corporations (Attachment C) Under this proposal, corporations (other than insurance companies) investing in tax-exempt obligations generally would be disallowed deductions for a portion of their interest expense equal to the portion of their total assets that is comprised of tax-exempt investments. For example, if one percent of a corporate taxpayer’s assets were tax-exempt bonds, one percent of the taxpayer’s interest expense would be disallowed. This proposal would be effective for taxable years beginning after the date of enactment with respect to obligations acquired after the date of first committee action. 4. Information Return Failure to File Penalties (Attachment D) The proposal would increase the maximum penalty for failure to file correct information returns -- currently set at $50 per return -- to the greater of $50 per return or 5 percent of the aggregate amount required to be reported. The increased penalty would not apply if the total amount actually reported by the taxpayer on all returns filed for the calendar year was at least 97 percent of the amount required to be reported. The proposal would not change the calendar- year caps on penalties for failure to file correct information returns. The proposal would apply to returns the due date for which (without regard to extensions) is more than 90 days after date of enactment. 5. Dividends Received Deduction (Attachment E) The budget proposal also contains three changes to the dividends received deduction. First, the 70 percent deduction for dividends received by corporations holding less than 20 percent of the payor’s stock would be reduced to 50 percent. Second, the deduction generally would be unavailable if the 46- day holding period for the stock (or the 91-day period for certain preferred stock) is not satisfied by the taxpayer over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend. These changes would apply to dividends paid or accrued more than 30 days after the date of enactment. The third change to the dividends received deduction would be to deny the deduction for preferred stock with certain non-stock characteristics. Generally, the deduction would be eliminated for dividends on "limited term preferred stock." For this purpose, preferred stock includes only stock that it is limited and preferred as to dividends and that does not participate in corporate growth to any significant extent. Stock is generally treated as having a limited term if (1) the issuer or holder have specified redemption obligations or rights, or (2) the dividend rate on the stock varies with reference to interest rates, commodity prices, or similar indices. This proposal would apply to dividends on stock issued more than 30 days after the date of enactment. 6. Denial of Interest Deductions on Certain Debt Instruments (Attachment F) The proposal would effectively treat certain corporate debt instruments as equity for federal income tax purposes. Thus, the proposal would generally deny deductions for interest and original issue discount ("OID") in the following circumstances: (1) certain debt instruments that have a maximum term of more than 15 years and are not shown as indebtedness on the balance sheet of the issuer (this also applies to certain structures in which a debt instrument is issued to a related party and the debt is eliminated in the consolidated balance sheet that includes the issuer and the related party); (2) certain debt instruments that are payable in stock of the issuer or a related party (this includes, among other things, convertible instruments and instruments for which the amount payable is based upon the value of the stock of the issuer or related party); and (3) certain debt instruments having a maximum weighted average maturity of more than 40 years. The proposal would be effective generally for instruments issued on or after the date of first committee action. 7. Interest Accruals on Pools of Debt Instruments (Attachment G) 3 See Institute Memorandum to Tax Members No. 9-88, dated February 12, 1988. - 3 - The proposal would extend the rules for determining interest accruals on instruments issued by real estate mortgage investment conduits ("REMICs"), and mortgages held by REMICs, to pools of debt instruments that have similarly uncertain payment schedules. Specifically, this proposal would require taxpayers to use the "catch-up" method (section 1272(a)(6)) with a reasonable prepayment assumption for purposes of determining the amount of interest or OID income that accrues on a pool of debt instruments. The proposal would be effective for taxable years beginning after the date of enactment. 8. Deferral of Interest Deductions on Certain Convertible Debt (Attachment H) The proposal would defer an issuer’s deduction for OID and interest on certain convertible debt instruments until payment. For this purpose, convertible debt generally includes debt (1) that is exchangeable for stock of a party related to the issuer, (2) with cash-settlement conversion features, and (3) issued with warrants (or similar instruments) as part of an investment unit in which the debt instrument may be used to satisfy the exercise price of the warrant. Conversion into the stock of the issuer or a related party would not be treated as a payment of accrued OID for this purpose. In addition, payments in equity of the issuer or a related person, and payments in cash, the amount of which is determined by reference to the value of such equity, would also be disregarded. The proposal would be effective generally for convertible debt issued on or after the date of first committee action. 9. Conversions of Subchapter C Corporations (Attachment I) The proposal would modify the rules under section 1374 requiring that gain be recognized upon the conversion of a Subchapter C corporation to a Subchapter S corporation only to the extent that assets held on the conversion date are sold within the next ten years. Specifically, the proposal would repeal section 1374, and require current gain recognition, for any conversion involving a Subchapter C corporation with stock valued at more than $5 million at the time of conversion. The proposal would apply to Subchapter S elections that are first effective for taxable years beginning after January 1, 1998 and to acquisitions (e.g., the merger of a C corporation into an S corporation) after December 31, 1997. Although section 1374 does not apply, by its terms, to transactions involving RICs, in Notice 88-19 the Internal Revenue Service ("IRS") applied "analogous" rules to conversions and mergers of non-RICs into RICs.3 This proposal provides that the Notice will be updated so that non-RICs with values of more than $5 million will not be permitted to convert into or merge with RICs on a tax-free basis. 10. IRA Expansion (Attachment J) The budget proposal also would expand availability of the IRA by (1) gradually doubling by the year 2000 the

Adjusted Gross Income thresholds and phase-out ranges applicable to the deductible IRA and indexing these thresholds and the present annual contribution limit of $2,000 for inflation, (2) eliminating the 10% early withdrawal penalty for certain special purpose withdrawals from IRAs and (3) establishing a new, back-loaded "Special IRA." Contributions to this Special IRA, which would be permitted in amounts up to $2,000 (offset against contributions to the deductible IRA), would not be tax deductible, but distributions of the contributions would be tax-free. For contributions remaining in the Special IRA account for five years, distribution of the earnings on the contributions also would be tax-free. Withdrawals during the five-year period would be subject to ordinary income tax and a 10% early withdrawal tax, unless special purpose withdrawal criteria are satisfied. * * * We will keep you informed of developments. Anne M. Barr Associate Counsel - Tax Russell G. Galer Assistant Counsel - Pension Attachment (in .pdf format) 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 Information Resource Center at (202)326-8304, and ask for this memo’s attachment number: 8639.
