INVESTMENT COMPANY INSTITUTE

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CAPITAL GAINS NOMENCLATURE

[9394] November 6, 1997 TO: TAX COMMITTEE No. 39-97 ACCOUNTING/TREASURERS COMMITTEE No. 44-97 MARKETING POLICY COMMITTEE No. 33-97 DIRECT MARKETING COMMITTEE No. 24-97 SALES FORCE MARKETING COMMITTEE No. 24-97 PUBLIC INFORMATION COMMITTEE No. 30-97 SHAREHOLDER COMMUNICATIONS COMMITTEE No. 16-97 OPERATIONS COMMITTEE No. 37-97 TRANSFER AGENT ADVISORY COMMITTEE No. 62-97 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 41-97 UNIT INVESTMENT TRUST COMMITTEE No. 64-97 RE: CAPITAL GAINS NOMENCLATURE ____ Overview The Institute has discussed with members of several committees the nomenclature that they are planning to use during 1997 to describe the "types" of capital gains that, in prior years, all received the same "long-term" gain treatment. To maintain consistency with how the Internal Revenue Service ("IRS") describes these types of gains in communications with taxpayers and to minimize shareholder confusion, the members contacted plan to use the following terms to describe the three subcategories of "long-term" gain (i.e., gain on assets held for more than one year): "28 percent rate gain" (i.e., gain taxed at a 28 percent maximum rate); "unrecaptured section 1250 gain" (i.e., gain taxed at a 25 percent maximum rate); and "20 percent rate gain" (i.e., gain taxed at a 20 percent maximum rate). Background Under the Internal Revenue Code (the "Code"), a capital gain is treated as either a "short-term" gain, if derived from an asset held for one year or less, or a "long-term" gain, if derived from an asset held for more than one year. The Taxpayer Relief Act of 1997 ("the 1997 1 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. 2 See Institute Memorandum to Tax Members No. 37-97, Accounting/Treasurers Members No. 40-97, Operations Members No. 22-97, Closed-End Investment Company Members No. 29-97, Unit Investment Trust Members No. 40-97 and Transfer Agent Advisory Committee No. 56-97, dated October 10, 1997. 3 See also Institute Memorandum to Tax Members No. 38-97, Accounting/Treasurers Members No. 42- 97, Broker/Dealer Advisory Committee No. 16-97, Closed-End Investment Company Members No. 30- 97, Operations Members No. 23-97, Transfer Agent Advisory Committee No. 57-97 and Unit Investment Trust Members No. 42-97, dated October 17, 1997. - 2 - Act")1 amended the Code to impose tiered maximum rates of tax on long-term capital gains realized by individual investors, including shareholders in regulated investment companies ("RICs"). For individuals in tax brackets of 28 percent or higher, the new maximum rates are 28 percent, 25 percent and 20 percent. For individuals in the 15 percent rate bracket, the new maximum rates are 15 percent and 10 percent. Gain taxed at a 28 percent maximum rate (15 percent for "15-percent-rate taxpayers") includes gain on (1) assets held for more than one year that are sold before May 7, 1997; (2) assets held for more than one year, but not more than 18 months, that are sold after July 28, 1997; and (3) "collectibles" (e.g., gold and platinum bullion) held for more than one year. While gains on assets held for twelve to eighteen months were called "mid-term" gains in the 1997 Act, the technical corrections legislation approved unanimously last month by the House Ways and Means Committee, with the support of the Treasury Department, uses the term "28 percent rate gain to describe all gains in this category." 2 As the term "28 percent rate gain" also is used on the Schedule D to the IRS Form 1040 Individual Income Tax Return (attached, which is the schedule used by individuals to report capital gains and losses),3 the members contacted will describe these gains using the term "28 percent rate gain." Gain taxed at a 25 percent maximum rate (15 percent for "15-percent-rate taxpayers") includes only the portion of any gain on depreciable real property held for more than 18 months (one year in the case of dispositions after May 6, 1997 and before July 29,1997) that is attributable to straight-line depreciation. As the 1997 Act and Schedule D use the term "unrecaptured section 1250 gain," the members contacted will describe these gains using the term "unrecaptured section 1250 gain." Gain taxed at a 20 percent maximum rate (10 percent for "15-percent-rate taxpayers") includes gain on assets held for (1) more than one year that are sold after May 6, 1997 and before July 29, 1997 and (2) more than 18 months that are sold after July 28, 1997. While the 1997 Act uses the term "adjusted net capital gain" to describe these gains, they are not reported separately on Schedule D and hence are not mentioned in the IRS tax reporting instructions. To maintain consistency with the nomenclature that will be used to describe the other type of long- term gain that will be prevalent in the investment company industry (i.e., 28 percent rate gain), 4 See Institute Memorandum to Tax Members No. 41-97, Accounting/Treasurers Members No. 44-97, Operations Members No. 25-97, Closed-End Investment Company Members No. 33-97, Unit Investment Trust Members No. 46-97, Transfer Agent Advisory Committee No. 61-97 and Broker/Dealer Advisory Committee No. 17-97, dated October 28, 1997. 5 In addition, a RIC shareholder must report on line 11 of Schedule D the amount of any long-term gain retained by the RIC and reported to the shareholder on IRS Form 2439 ("Notice to Shareholder of Undistributed Long-Term Capital Gains"). - 3 - the members contacted will describe gains taxed at a 20 percent maximum rate using the term "20 percent rate gain." Reporting Capital Gain Distributions to RIC Shareholders Individual RIC shareholders will notice many changes in the tax reporting required with respect to RIC capital gain dividends paid during 1997. For example, because of the new maximum capital gains rates imposed by the 1997 Act, the IRS has announced4 that RICs generally must report for 1997 not only the amount of each RIC shareholder’s capital gain dividend (reported, as in prior years, in Box 1c of the IRS Form 1099-DIV or acceptable substitute), but also information sufficient to determine the amount of "28 percent rate gain" and "unrecaptured section 1250 gain." Long-term capital gains (on assets held for more than one year) are reportable by investors to IRS on Part II of Schedule D. All capital gain dividends are included in the amount placed on line 13, column (f) of Part II of Schedule D.5 In addition, two subcategories of long- term gain (one or both of which may be included within a capital gain dividend) are reported elsewhere on Schedule D. Specifically, "28 percent rate gains" are placed by all individual taxpayers (regardless of tax bracket) on line 13, column (g) of Part II of Schedule D, while unrecaptured section 1250 gains are placed on line 25 of Part IV of Schedule D. The one portion of a capital gain dividend that is not separately reported on Schedule D is the 20 percent rate gain portion, which is reported only as part of the total long-term gain on line 13, column (f) of Part II of Schedule D. The net amount of each taxpayer’s gains taxable at either a 20 percent rate or a 10 percent rate is determined by the taxpayer as part of the computations that appear in Part IV of Schedule D ("Tax Computation Using Maximum Capital Gains Rates"). Any information reported by RICs regarding these gains, however, cannot be placed directly on line 36 (where the net amount of gains taxable at a 10 percent rate is determined) or line 40 (where the net amount of gains taxable at a 20 percent rate is determined), as IRS requires the form to be completed in its entirety and unrelated transactions could affect the amounts reported on these lines. - 4 - Capital Gains on Dispositions of RIC Shares Individual RIC shareholders also will be required to report the amount of any capital gain or loss realized upon the redemption or sale of their shares. Any short-term gain and loss will be reportable in Part I of Schedule D on line 1. Any long-term gain and loss will be reportable in Part II of Schedule D on line 8. Column (f) of line 8 is used to report the full amount of the gain or loss; column (g) of line 8 is used to report any 28 percent rate gain or loss (even if, as discussed above, the taxpayer is in the 15 percent rate bracket). The only reporting obligation on RICs with respect to dispositions of RIC shares is to report the gross proceeds on IRS Form 1099-B. In prior years, some RICs that voluntarily provided shareholders with average cost basis information also calculated the gain or loss and reported whether it was "long-term" or "short-term." Any RIC that decides to provide shareholders with 1997 tax information regarding the maximum rate at which gain on shares held for more than one year are taxed, and that also utilizes the nomenclature discussed above, would describe the redemption transactions as producing either "28 percent rate gains and losses" or "20 percent rate gains and losses." Keith D. Lawson Associate Counsel - Tax Attachment

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