

MEMO# 3581

March 16, 1992

SENATE APPROVES TAX BILL

11/ The House-passed bill is discussed in Institute Memorandum to Tax Members No. 12-92, Closed-End Fund Members No. 10-92, Unit Investment Trust Members No. 14-92, Accounting/Treasurers Members No. 8-92, Operations Members No. 8-92, International Committee No. 4-92, and Transfer Agent Advisory Committee No. 11-92, dated March 2, 1992. 22/ A separate memorandum to Pension Members describes the Senate bill provisions (1) expanding eligibility for deductible Individual Retirement Account ("IRA") contributions and creating a new IRA to which nondeductible contributions could be made (essentially last fall's Bentsen-Roth IRA), (2) permitting March 16, 1992 TO: TAX MEMBERS NO. 14-92 CLOSED-END FUND MEMBERS NO. 12-92 UNIT INVESTMENT TRUST MEMBERS NO. 17-92 ACCOUNTING/TREASURERS MEMBERS NO. 10-92 OPERATIONS MEMBERS NO. 10-92 INTERNATIONAL COMMITTEE NO. 6-92 INSTITUTIONAL FUNDS COMMITTEE NO. 2-92 TRANSFER AGENT ADVISORY COMMITTEE NO. 12-92 RE: SENATE APPROVES TAX BILL

The United States Senate has approved, by a vote of 50-47, its version of the "Family Tax Fairness, Economic Growth and Health Care Awareness Act of 1992." Because this bill is not identical to the tax bill that recently passed the House 1/1, the differences must be resolved by a House-Senate Conference. Any bill emerging from the Conference that is subsequently approved by both the House and the Senate would be sent to the President for signature or veto. The Senate bill provisions of interest to regulated investment companies ("RICs") that are discussed in this memorandum relate to (1) modified taxation of capital gains, (2) foreign tax simplification, (3) repeal of investment restrictions applicable to nuclear decommissioning funds, (4) the amended Taxpayer Bill of Rights and (5) certain administrative changes. 2/2 certain penalty-free withdrawals from IRAs and (3) providing pension simplification. 33/ Unlike the House bill, the Senate bill does not provide for indexing the cost basis of capital assets for inflation. - 1 - Similarities and differences between the House and Senate bills are discussed. Relevant portions of the Senate bill and its Technical Explanation may be obtained by calling the undersigned at (202) 955-3585. I. Modified Taxation of Capital Gains The Senate bill contains two provisions that modify the taxation of capital gains. First, like the House bill, the Senate bill excludes from tax 50 percent of the capital gains realized upon the disposition of qualified small business stock acquired by the taxpayer at its original issuance and held for more than five years. As in the House bill, RIC shareholders would be eligible to claim the 50 percent exclusion for gains on the sale of qualified small business stock originally issued to the RIC only if (1) the RIC held the stock for more than five years and (2) the RIC shareholder held the RIC stock on which the capital gain dividend was paid from the date the RIC acquired the qualified small business stock through the date the qualified small business stock was sold. Second, the Senate bill provides progressive capital gains tax rates for individuals.3/3 The marginal rate on qualified capital gain would be 5 percent on gains otherwise taxed in the 15 percent bracket, 19 percent on gains

otherwise taxed in the 28 percent bracket, 23 percent on gains otherwise taxed in the 31 percent bracket and 28 percent on gains otherwise taxed in the new 36 percent bracket. As under current law, capital gains realized upon the disposition of a RIC's portfolio securities would retain their character for purposes of reduced capital gains tax rates when distributed to the RIC's individual shareholders as capital gain dividends. In addition to changing tax rates, the bill would change the treatment of capital gains in two other ways. First, the entire amount of qualified capital gain would be included in alternative minimum taxable income. Second, the holding period for long-term capital gain treatment would be increased under the Senate bill from more than one year to more than two years. The new capital gains rates would apply to taxable years ending after January 31, 1992. For a taxable year beginning on - 2 - or before that date, the new rates would apply to the lesser of (i) the net capital gain for the taxable year or (ii) the net capital gain determined by taking into account only gain or loss attributable to the portion of the year after January 31, 1992. With respect to distributions of net capital gain to RIC shareholders, the new rates would apply only to gains realized by the RIC after January 31, 1992. - 3 -

II. Foreign Investment Provisions The Senate bill provides new rules for (1) taxing investments in passive foreign corporations ("PFCs") and (2) claiming the foreign tax credit when the amount of an individual's creditable foreign taxes is no more than \$200. These Senate provisions are in all relevant respects comparable to the provisions in the House bill. As discussed in greater detail in the memorandum on the House bill that we recently sent to you, the mark-to-market system applicable to investments by RICs in PFCs will generally eliminate the RIC-level tax that applies under existing law. Also like the House bill, the Senate bill contains a transition rule that would require RICs to (1) mark to market all PFIC stock in their portfolios on the first day of the RIC's first taxable year beginning after December 31, 1992, (2) pay a nondeductible interest charge on the tax that would have been collected had the PFC shares been marked to market in the prior years and (3) distribute the mark-to-market gains to their shareholders.

III. Repeal of Investment Restrictions Applicable to Nuclear Decommissioning Funds As you know, the Institute has supported proposed Treasury regulations that would permit nuclear decommissioning funds to invest in RICs which meet certain conditions regarding assets and conduct. (See Institute Memoranda to Tax Committee No. 27-90 and SEC Rules Committee No. 47-90, dated September 4, 1990; and to Tax Committee No. 38-90 and Institutional Funds Committee No. 6-90, dated December 20, 1990.) The Senate bill would expand the investment options of nuclear decommissioning funds far beyond the scope of the proposed Treasury regulations by completely eliminating the present-law investment restrictions that apply to nuclear decommissioning funds, effective for taxable years beginning after December 31, 1991.

IV. Taxpayer Bill of Rights The Senate bill would expand the Taxpayer Bill of Rights provision relating to tax information returns, that is also contained in the House bill, by requiring that IRS Forms 1099 (and acceptable substitutes) contain the name, address and phone number of the payor's "information contact." Under the House bill, a payor would be required to include on the information return only its telephone number. This provision would apply to statements required to be furnished after December 31, 1992. In addition, the Senate bill would provide relief from retroactive application of Treasury regulations by providing that the effective date for temporary and proposed regulations would generally be no earlier than the date of the publication in the Federal Register. Final regulations may take effect from the - 4 - date of publication of the temporary or proposed regulations to - 5 - which they relate. An earlier effective date for Treasury regulations could be provided only by (1) a special legislative grant authorizing Treasury to prescribe the effective date with respect to a statutory provision and (2) Treasury permitting taxpayers to elect to apply temporary or proposed regulations retroactively. This provision would apply with respect to any temporary or proposed regulation published on or after February 20, 1992 and to any

temporary or proposed regulation published before February 20, 1992 which is published as a final regulation after that date. V. Administrative Provisions The Senate bill also contains two administrative changes that were included in the House bill. First, the bill would replace the tax deposit system used to deposit amounts withheld pursuant to the backup withholding rules of Code section 3406. Three basis deposit timetables would be provided under the bill. First, the eighth-monthly system would be replaced by a requirement to make deposits twice a week, on Tuesdays and Fridays. Second, the bill would retain present law rules requiring large depositors to make deposits the next day when they accumulate to \$100,000 or more. Finally, deposits must be made only once a month, on or before the fifteenth day of the following month, if the amount required to be deposited was \$12,000 or less per quarter for the previous one-year base period. These deposit rules would apply to payments made after December 31, 1992. The second administrative provision would redefine the term "reproduction" for purposes of the Code section 6103(p) recordkeeping requirements for returns and return information. Under the bill, the term would include a reproduction from a digital image. This provision would be effective on the date of enactment. VI. Provisions From House Bill Not Included In Senate Bill Simplification provisions included in the House bill that are not included in the Senate bill include those relating to mutual fund tax simplification and the amortization of intangibles. Any provision in either bill is eligible for inclusion in the final bill. * * * We will keep you informed of developments regarding this legislation. Keith D. Lawson Associate Counsel - Tax - 6 -

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