

MEMO# 7972

June 13, 1996

JUNE 28 MEETING ON TAX DIVERSIFICATION AND EXCISE TAX ISSUES

1 For example, a futures contract would be valued for section 851(b)(4) purposes based upon its market value and not the value of the underlying securities. VIA FAX June 13, 1996 TO: TAX COMMITTEE No. 22-96 ACCOUNTING/TREASURERS COMMITTEE No. 26-96 RE: JUNE 28 MEETING ON TAX DIVERSIFICATION AND EXCISE TAX ISSUES

A meeting has been scheduled for June 28, at 10:30 a.m. in the Institutes David Silver Conference Room, to discuss two issues raised at the June 11 Tax Committee meeting. The June 28 meeting first will consider a proposed "safe harbor" under which the liabilities of a regulated investment company ("RIC") would be disregarded for section 851(b)(4) diversification test purposes. The June 28 meeting also will consider proposals for modifying the section 4982 excise tax regulations. Lunch will be served during the meeting. Members planning to attend the June 28 meeting should fax the attached response form to Theresa Brice at 202-326-5839 no later than Monday June 24. A memorandum discussing a proposed "safe harbor" modification to the excise tax regulations will be distributed to anyone planning to attend the meeting, and to others upon request. Diversification Test Safe Harbor As you know, the section 851(b)(4) diversification tests are based upon the value of a RICs "assets." Existing Internal Revenue Service ("IRS") guidance does not fully explain how instruments or positions with negative values (i.e., liabilities) should be treated under section 851(b)(4). One proposal for valuing negative positions under section 851(b)(4)s gross income tests would be simply to ignore them. Under this proposal, the numerators and the denominator under the section 851(b)(4) tests would be calculated using the gross fair market values¹ of all assets with positive values (i.e., a "gross assets" test). Negative positions held by a RIC, e.g., short positions, would not be taken into account. Consequently, where a RIC hedged part of its risk on a portfolio position by entering into an offsetting short position, the offsetting short² For example, if a RIC held ABC stock worth \$1,000 and sold short \$500 of ABC stock, the short sale would be ignored and the RIC simply would be treated as holding ABC stock worth \$1,000. - 2 - position would be ignored (i.e., no netting would be required) and only the positive position would be taken into account.² To relieve potential concerns that a taxpayer holding a nondiversified portfolio of securities might enter into multiple offsetting positions, thereby "artificially" increasing the gross assets denominator and creating a "diversified" portfolio, it has been suggested that the safe harbor be limited, such as to situations where the ratio of gross assets to net assets did not exceed 120 percent. At the June 28 meeting, we will consider (1) whether a proposed section 851(b)(4) "safe harbor," where liabilities are ignored, should be advanced, (2) if so, what the industry needs as a maximum gross assets/net assets ratio

for safe harbor eligibility (e.g., 120 percent, 150 percent, 180 percent) and (3) for purposes of the ratios net assets figure, how should various fund payables and other liabilities be treated. Modifications to Section 4982 Regulations The June 28 meeting also will consider whether the Institute should propose modifications to the excise tax minimum distribution regulations under section 4982. One proposal mentioned at the June 11 Tax Committee meeting would provide a safe harbor whereby the "grossed up required distribution" for the preceding calendar year would equal 100 percent of the taxable year-to-date ordinary income through December 31 (and capital gain net income through October 31) of the preceding calendar year. All income and distributions of all taxable years ending before the current calendar year would be disregarded. Under another proposal, the regulations would be modified to ensure sufficient earnings and profits to support any required distribution. Other issues and proposed regulatory solutions also will be considered at the meeting. * * *

* * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax
Attachment - 3 - ATTENDANCE RESPONSE FORM INVESTMENT COMPANY INSTITUTE TAX
DIVERSIFICATION AND EXCISE TAX ISSUES MEETING Friday, June 28, 1996 Please fax this
portion No later than Monday, June 24, 1996 to Theresa Brice Investment Company
Institute, 202-326-5839. YES NO ____ TAX DIVERSIFICATION AND EXCISE TAX ISSUES
MEETING 10:30 a.m. _____ or

____ COMMITTEE MEMBER'S NAME ALTERNATE'S NAME
____ COMPANY NAME Please check here if you
need special services due to a disability.

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