

**MEMO# 11138**

July 27, 1999

## **HOUSE OF REPRESENTATIVES APPROVES TAX LEGISLATION**

1 The relevant pension-related provisions in the bill will be summarized in a separate Institute Memorandum. [11138] July 27, 1999 TO: ACCOUNTING/TREASURERS MEMBERS No. 19-99 CLOSED-END INVESTMENT COMPANY MEMBERS No. 27-99 OPERATIONS MEMBERS No. 18-99 TAX MEMBERS No. 21-99 TRANSFER AGENT ADVISORY COMMITTEE No. 46-99 UNIT INVESTMENT TRUST MEMBERS No. 16-99 RE: HOUSE OF REPRESENTATIVES APPROVES TAX LEGISLATION

The House of Representatives has approved H.R. 2488, the "Financial Freedom Act of 1999" (hereinafter, "the bill"). As urged by the Institute, the bill would permit US funds (treated for federal tax purposes as regulated investment companies or "RICs") to "flow through" the character of interest and short-term capital gains to their foreign shareholders. President Clinton has indicated that he would veto the bill if it were presented to him in its current form because of the bill's excessively large tax cut provisions. The memorandum discusses the following attached provisions of interest to RICs and their shareholders:<sup>1</sup> (1) flow-through treatment for interest and short-term capital gains paid by RICs to their foreign shareholders; (2) a partial exclusion from income for dividends and interest; (3) a reduction in the maximum rate of tax on net capital gains of individuals from 20 percent to 15 percent; (4) the treatment of distributions of accumulated earnings and profits from a "non-RIC" year; (5) the treatment of income derived by RICs from interests in publicly traded partnerships; (6) the qualification of "specialized small business companies" or "SSBICs" as RICs and the treatment of gains on SSBIC stock; and (7) the treatment of gain from constructive ownership transactions, including certain "synthetic" investments in RICs. Flow Through of Interest and Short-Term Capital Gains to Foreign Investors (Attachment A) The bill generally would permit the character of interest and short-term capital gains to flow through a RIC to its foreign shareholders without imposition of US withholding tax. For these purposes, US-source and foreign-source interest that is free from foreign withholding tax under the domestic laws of the source country (such as interest from "Eurobonds") would be eligible for flow-through treatment. The bill would, however, deny flow-through treatment for interest from any foreign bond on which the source-country tax rate is reduced pursuant to a tax treaty with the United States. The provision would apply to taxable years beginning after December 31, 2004. <sup>2</sup> 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. The Institute fully supports this "flow-through" legislation because it would eliminate the US withholding tax barrier to foreign investment in US funds, while containing appropriate safeguards to ensure that (1) flow-through treatment applies only to interest

income that would be exempt from US withholding tax if received by a foreign investor directly or through a foreign fund and (2) foreign investors cannot avoid otherwise-applicable foreign tax by investing in US funds that qualify for treaty benefits under the US income tax treaty network.

**Reduction in Maximum Rate of Tax on Net Capital Gains of Individuals (Attachment B)** The bill would reduce the maximum rate of tax on net capital gains realized by individuals from 20 percent to 15 percent. Gains taxed under current law at a 10-percent rate would be taxed under the bill at a 7.5 percent rate. The 15-percent and 7.5-percent rates would apply under the bill for alternative minimum tax purposes. The 18-percent and 8-percent rates provided for “qualified 5-year gains” by the Taxpayer Relief Act of 19972 also would be repealed as obsolete. The reduced maximum capital gains rates would apply to taxable years ending on or after July 1, 1999. For any taxable year that includes July 1, 1999, only the net capital gains attributable to gains or losses properly taken into account for the part of the year on or after July 1, 1999 would be entitled to the benefits of these new maximum rates. In applying the effective date rules to distributions from RICs and certain other pass-thru entities, the determination of when gains and losses are properly taken into account would be made at the entity level.

**Partial Exclusion for Dividends and Interest (Attachment C)** The bill, as modified by a floor resolution, would provide individuals with a phased-in exclusion from income for dividends and interest. Specifically, the bill would permit individuals to exclude from income interest and dividends totaling: -- \$50 (\$100 in the case of a married couple filing a joint return) for 2001 through 2002; -- \$100 (\$200 in the case of a married couple filing a joint return) for 2003 through 2004; and -- \$200 (\$400 in the case of a married couple filing a joint return) for 2005 and thereafter. The income exclusion would be provided by proposed new section 116. Distributions by RICs would be eligible for the exclusion, subject to limitations provided by section 854 (as modified by the bill). For these purposes, the term “dividend” would exclude in all cases a RIC capital gain dividend. The provision would apply to taxable years beginning after December 31, 2000.

**Distribution of Accumulated Earnings and Profits from a Non-RIC Year (Attachment D)** The bill would make three modifications to the provisions of Subchapter M that impact certain RICs with accumulated earnings and profits from “non-RIC” years. A RIC may acquire such earnings and profits through either a conversion from non-RIC to RIC status or a merger with a non-RIC. First, the bill would amend section 852(c) to provide that any distribution made to satisfy the requirement that the RIC have no non-RIC earnings and profits as of the end of the taxable year “shall be treated . . . as made from the earliest earnings and profits accumulated in any taxable year to which the provisions of this part did not apply.” This would represent a change from current law under which distributions from earnings and profits essentially are treated as being made on a last in, first out basis. Second, the bill would provide that a distribution treated as being made from accumulated earnings and profits shall not be treated as a distribution for purposes of calculating the dividends paid deduction under section 852(b)(2)(D) or the “spillover” dividend rules of section 855. This change expressly would permit a RIC to use a spillover dividend to distribute its taxable income for a year in which it acquires non-RIC earnings and profits that it must distribute. Third, the bill would expand the “deficiency dividend” relief provided by section 852(e) where a failure to qualify under Subchapter M is attributable solely to a failure to distribute non-RIC earnings and profits. Under the provision, a deficiency-type distribution of non-RIC earnings and profits would permit the RIC to qualify in the initial year to which a failed determination under Subchapter M applied, in addition to subsequent years (before the deficiency-type distribution is made). These provisions would apply to distributions after December 31, 2000.

**Income Derived from Interests in Publicly Traded Partnerships (Attachment E)** The bill would amend section 851(b) to treat the gross amount of income derived by a RIC from an interest in a publicly traded partnership as qualifying income under Subchapter M. For this purpose, the bill

provides that qualifying income of a publicly traded partnership would be determined at the entity level, rather than on a "look-through" basis. The bill also would extend the special "passive loss" rules for publicly traded partnerships to RICs holding interests in such partnerships. Under section 469(k) (as modified by the bill), a RIC would be required separately to apply the passive loss rules with respect to items attributable to each publicly traded partnership interest. The provision would apply to taxable years beginning after December 31, 2000.

**Specialized Small Business Investment Companies (Attachment F)** A specialized small business investment company ("SSBIC") is defined as any partnership or corporation that is licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993). SSBICs make long-term loans to, or equity investments in, small businesses owned by persons who are socially or economically disadvantaged. SSBICs may qualify as RICs for federal tax purposes. For purposes of determining RIC status, the bill would treat (1) income derived by a SSBIC from a limited partner interest in a partnership whose business operations the SSBIC does not actively manage as qualifying income under section 851(b)(2); (2) the SSBIC as satisfying the 90-percent distribution requirement of section 852(a)(1) where the SSBIC distributes all income (without regard to long-term capital gains) that it is permitted to distribute under the Small Business Investment Act of 1958; and (3) the SSBIC as being adequately diversified under section 851(b)(3) to the extent its investments are permitted under the Small Business Investment Act of 1958. These provisions would apply to taxable years beginning after date of enactment. The bill would modify the treatment of disposition gain on publicly-traded securities by providing taxpayers with an expanded 180-day period following the sale or exchange of such securities to roll over the gain in a tax-free transaction to an investment in SSBIC preferred or common stock. Under present law, the roll-over period is limited to 60 days and preferred stock in an SSBIC is not a permissible investment. The bill would repeal the annual gain exclusion caps; the maximum lifetime gain exclusion amounts would be increased from \$500,000 to \$750,000 for an individual and from \$1,000,000 to \$2,000,000 for a corporation. In proposed new section 1202(k), the bill also would provide a 60 percent exclusion for gain realized by a taxpayer on SSBIC stock. These provisions would apply to sales or exchanges occurring after date of enactment. Finally, the bill would provide special rules to allow an SSBIC to convert from a corporation to a partnership on a tax-free basis within 180 days of enactment of the bill.

**Treatment of Gain from Constructive Ownership Transactions (Attachment G)** The bill would prevent the conversion of ordinary income or short-term capital gain into income eligible for long-term capital gain treatment with respect to certain "constructive ownership transactions" involving, among other things, an equity interest in a pass-thru entity (that would be defined to include a RIC). Under proposed new section 1260, a taxpayer generally would be treated as having entered into a constructive ownership transaction with respect to a pass-thru entity if the taxpayer: (1) holds a long position under a swap contract with respect to the entity; (2) enters into a forward or futures contract to acquire the entity; (3) is the holder of a call option, and is the grantor of a put option, with respect to the entity and the such options have substantially equal strike prices and substantially contemporaneous maturity dates; or (4) enters into one or more other transactions (or acquires one or more positions) that have substantially the same effect as a transaction described above. More specifically, the bill would (1) limit the amount of long-term gain to the long-term gain, if any, that the taxpayer would have received had an investment been made directly in the underlying pass- thru entity (an amount termed the "net underlying long-term capital gain") and (2) impose an interest charge on any deferred short-term gain. An exception to this treatment would be provided if all of the positions that are part of the transaction are marked to market. Under the bill's effective date, the constructive ownership provisions would apply to transactions entered into after July 11, 1999. Deanna

Flores Assistant Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment referred to in this Memo, please call the ICI Library at (202) 326-8304, and ask for attachment number 11138. ICI Members may retrieve this Memo and its attachment from ICINet (<http://members.ici.org>).

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