INVESTMENT COMPANY INSTITUTE

MEMO# 10077

June 26, 1998

CONFERENCE AGREEMENT ON IRS RESTRUCTURING BILL

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. [10077] June 26, 1998 TO: TAX MEMBERS No. 18-98 ACCOUNTING/TREASURERS MEMBERS No. 16-98 OPERATIONS MEMBERS No. 17-98 CLOSED-END INVESTMENT COMPANY MEMBERS No. 19-98 UNIT INVESTMENT TRUST MEMBERS No. 14-98 INTERNATIONAL MEMBERS No. 13-98 TRANSFER AGENT ADVISORY COMMITTEE No. 33-98 BROKER/DEALER ADVISORY COMMITTEE No. 10-98 RE: CONFERENCE AGREEMENT ON IRS RESTRUCTURING BILL ____ The Conference Committee this week resolved all differences between the House and Senate versions of the Internal Revenue Service Restructuring and Reform Act of 1998 ("the 1998 Act") and reported it for final approval. On June 25, the House approved the bill by a vote of 402 to 8. The Senate is expected to approve the 1998 Act upon returning from the Fourth of July recess. President Clinton has indicated that he will sign this legislation into law. The 1998 Act contains several tax provisions of interest to regulated investment companies ("RICs") and their shareholders. Included in the 1998 Act are a reduction in the holding period requirement (from 18 months to 12 months) for 20 percent rate gain treatment, technical corrections to the Taxpayer Relief Act of 1997 ("the 1997 Act"),1 IRS Appeals Office review of IRS agent determinations that municipal bonds should be treated as taxable, tax information reporting changes and the creation of an accountant/client tax advice privilege. 2 The attachments include the statutory language and, where sufficiently detailed to be helpful, the Statement of Managers' explanation. 3 The 1997 Act provides that taxpayers in the 15 percent rate bracket are taxed on these gains at a 10 percent rate. 4 The 20 percent maximum rate also applied, as originally enacted, to assets held for more than 12 months that were sold after May 6, 1997 and before July 29, 1997. 5 Beginning in 1999, RIC capital gain dividends generally will be taxable at only one maximum rate, i.e., 20 percent. Some RICs, however, may have other types of long-term gains not affected by the 1998 Act, including "collectibles gain" that remains taxable at a 28 percent maximum rate and "unrecaptured section 1250 gain" that remains taxable at a 25 percent maximum rate. 6 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. 7 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. 12-Month Holding Period Requirement for 20-Percent Rate Gain Treatment (Attachment A)2 The 1997 Act created a multiple-tier capital gains rate structure by reducing from 28 percent to 20 percent3 the maximum tax rate for gains on certain assets, including those sold after July 28, 1997 that were held for more than 18 months.4 One effect of this multiple-tier structure was that capital gain dividends paid by a RIC to its shareholders during 1997 typically were taxable in part at a 28 percent maximum rate (e.g., for certain gains on assets held for more than 12 months but not more than 18 months) and in part at a 20 percent maximum rate (e.g., for certain gains on assets held for more than 18 months). The 1998 Act eliminates the 18-month holding period requirement for property sold after December 31, 1997. Thus, any gain on the disposition after 1997 of RIC shares held for more than 12 months will be taxed at a 20 percent maximum rate. However, if any portion of any RIC capital gain dividend paid during 1998 is attributable to any gain on assets sold during 1997 that is taxed, under the 1997 Act, at a 28 percent maximum rate, this portion of the 1998 dividend apparently will remain taxable at a 28 percent maximum rate.5 Technical Corrections The 1998 Act includes technical corrections to the 1997 Act, including significant revisions to the capital gains rules and two technical corrections, urged by the Institute, relating to RIC investments in passive foreign investment companies ("PFICs") and application to RICs of the new holding period requirements for claiming foreign tax credits. Capital Gains (Attachment B) First, the 1998 Act enacts the capital gains technical corrections that were considered last fall by the House of Representatives6 and taken into account by IRS in administering the tax laws during 1997.7 These technical corrections include changes to the methodology for netting gains and losses from different categories and a provision treating all transactions the gain on 8Since 1992 (following the release of IRS Notice 92-53, which permitted reliance for one year on proposed mark-to- market regulations, and informal administrative assurances that the regulations would be effective, when finalized, retroactive to the expiration of the Notice), RICs have marked their PFIC shares to market and included in income any excess of the fair market value of the stock over its adjusted basis. This treatment was necessary to avoid an unintended RIC-level tax that could not be eliminated by distributing to the RIC’s shareholders the income arising from these investments. See, e.g., Institute Memorandum to Tax Members No. 73-92, Accounting/Treasurers Members No. 41-92, Closed-End Fund Members No. 45-92 and International Members No. 25-92, dated November 9, 1992. 9 Any tax that cannot be credited because of the new holding period requirement remains deductible. - 3 - which would be taxable at a 28 percent maximum rate as within one category called "28 percent rate gain." PFIC Unreversed Inclusions (Attachment C) The 1998 Act also resolves a problem arising from the unique circumstances pursuant to which RICs were marking to market their PFIC shares (pursuant to formal and informal administrative guidance from IRS and Treasury) before legislation permitting mark-to-market treatment was enacted in 1997.8 Specifically, the 1997 Act permitted taxpayers such as RICs both to elect to mark to market each year their PFIC shares and, in certain cases, to take an ordinary deduction for (a) any excess of the adjusted basis of the PFIC shares over the fair market value of the shares as of the close of the taxable year, and (b) a loss on the disposition of the PFIC shares. The ability to take an ordinary deduction was limited to the amount of any net mark-to-market gains with respect to the PFIC shares that the taxpayer included in income pursuant to the 1997 Act (an amount known as the "unreversed inclusion"). As recommended by the Institute, the 1998 Act permits a RIC to include it its calculation of unreversed inclusions all amounts that it has treated as PFIC mark-to-market income, whether pursuant to the administrative guidance or the statute. This technical correction applies as if it were enacted as part of the 1997 Act (i.e., to taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons). Foreign Tax Credit Holding Period Requirement (Attachment D) Another technical correction recommended by the Institute resolves an unintended complexity created as part of the 1997 Act’s modification of the rules for claiming foreign tax credits. In addition to simplifying the reporting requirements applicable to individuals claiming foreign tax credits of less than $300 ($600 on a joint return), the 1997 Act provided that no credit for foreign taxes may be claimed by a taxpayer unless the stock is held by the taxpayer for at least 16 days around the record date for the dividend. In the case of foreign taxes paid by RICs (which may be "flowed through" pursuant to section 853 to the RIC’s shareholders), the 16-day holding period requirement must be met both at the RIC level, with respect to the foreign stock’s dividend, and at the RIC shareholder level, with respect to the RIC shares’ dividend.9 10 See Institute Memorandum to Tax Committee No. 22-98 and Unit Investment Trust Committee No. 19-98, dated June 17, 1998. - 4 - The problem for RIC shareholders arising from the 1997 Act’s new 16-day holding period requirement is that the 1997 Act did not make a corresponding change to the rules under section 853 which provide that a RIC electing flow-through treatment effectively must gross up its dividends by all foreign taxes that it pays. Thus, a RIC electing section 853 treatment effectively would be required by the 1997 Act to gross up its dividend for all foreign taxes, including those for which the credit is denied by the new holding period requirement. The RIC’s shareholders also must be advised of the portion of the grossed-up amount that must be deducted, rather than credited, because of the new holding period requirement. Adopting the Institute’s suggestion, the 1998 Act provides that RICs electing flow- through treatment may deduct any tax that, because the RIC failed to meet the 16-day holding period requirement, cannot be claimed as a credit at the RIC shareholder level. Under this approach, the RIC shareholders’ dividends would be grossed up only by foreign taxes for which they can claim credit. This technical correction applies as if it were enacted as part of the 1997 Act (i.e., with respect to any dividend paid or accrued more than 30 days after enactment of the 1997 Act (which occurred on August 5, 1997)). IRS Appeals Office Review of Adverse Determinations of Tax-Exempt Bond Status (Attachment E) The 1998 Act also provides issuers of municipal bonds with a new right when IRS examiners determine that a previously-issued municipal bond is taxable. Specifically, the 1998 Act instructs IRS to amend its administrative procedures to provide that issuers in such a case "shall have an administrative appeal of right to a senior officer of the Internal Revenue Service Office of Appeals." This directive to IRS is effective on the date of enactment. While the Conference Agreement does not include the Senate provision that would have provided issuers with the right to file a declaratory judgment action in the U.S. Tax Court to determine the tax-exempt status of the previously-issued bonds,10 the issue is discussed in the Statement of Managers accompanying the Act. In particular, the Statement of Managers provides that the conferees intend for Congress to evaluate judicial remedies in future legislation once the IRS’ tax-exempt bond examination program has developed more fully and the Congress is better able to ensure that any future measure protects all parties with an interest in these determinations (including issuers, bondholders and the Federal Government). Due Dates for Providing Year-End Tax Information (Attachment F) The 1998 Act provides that any information return the filing of which is required under sections 6041 through 6053 -- including Forms 1099-DIV (dividend income) and 1099-B (gross proceeds) -- will be treated as filed timely with IRS if filed electronically by March 31 (rather than the present-law due date of February 28). This change to the information reporting due date applies to returns required to be filed after December 31, 1999. - 5 - In addition, the 1998 Act requires the Secretary of the Treasury to conduct a study, to be completed no later than June 30, 1999, evaluating the effect of extending from January 31 to February 15 the deadline for providing Forms 1099-DIV and 1099-B (among others) to payees, including RIC shareholders. Electronic Filing (Attachment G) Other provisions of the 1998 Act, generally effective on the date of enactment, that are intended to encourage electronic filing would: require IRS to develop procedures for the acceptance of signatures in digital or other electronic form; permit IRS to provide alternative methods of signing returns, declarations, statements and other documents; treat for all purposes (including penalties of perjury declarations) any document signed under one of these alternative methods in the same manner as though actually signed; and require IRS to establish procedures, in the case of taxable periods beginning after 1998, for all tax forms, instructions and publications created for the most recent 5-year period to be made available electronically on the Internet in a searchable database at approximately the same time such records are available to the public in paper form. Accountant/Client Tax Advice Privilege (Attachment H) The 1998 Act generally extends the attorney/client privilege to "tax advice" provided by certified public accountants and other "federally authorized tax practitioners." The privilege may be asserted only in noncriminal tax matters before the IRS and in Federal Court in noncriminal tax proceedings where the United States is a party. Moreover, the privilege may be waived in the same manner as the attorney-client privilege and cannot be asserted to prevent disclosure of information to any regulatory body other than the IRS. This provision applies to communications made on or after date of enactment. Keith D. Lawson Senior Counsel Attachment - 6 - 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 Library Services Division at (202)326-8304, and ask for this memo’s attachment number: 10077.