

MEMO# 6625

February 3, 1995

INSTITUTE STATEMENT ON INDEXING COST BASIS FOR INFLATION

February 3, 1995 TO: TAX COMMITTEE No. 6-95 ACCOUNTING/TREASURERS COMMITTEE No. 8-95 OPERATIONS COMMITTEE No. 6-95 TRANSFER AGENT ADVISORY COMMITTEE No. 11-95 CLOSED-END FUND COMMITTEE No. 5-95 RE: INSTITUTE STATEMENT ON INDEXING COST BASIS FOR INFLATION

As you may know, the "Contract With America" advanced last fall by Republican candidates for the U.S. House of Representatives included two provisions relating to the taxation of capital assets. First, the Contract included a 50 percent deduction for net long-term capital gains. Second, the Contract included a provision to increase or "index" for inflation the cost basis of capital assets held for more than one year. H.R. 9 (the "Job Creation and Wage Enhancement Act of 1995"), which was introduced in the House of Representatives by Ways and Means Committee Chairman Bill Archer and others on the first legislative day of the 1995 Congressional session, includes both of these proposals. The indexing provisions in H.R. 9 (attached) would permit regulated investment companies ("RICs") to index the cost basis of their indexing-eligible assets, i.e., domestic common stock (but neither debt nor, in general, foreign securities). RIC shareholders would index the cost basis of their RIC shares to the extent that the underlying RIC portfolio consists of indexing-eligible assets. Specifically, RIC shares would be treated as an "indexed asset" eligible for indexing for any calendar month in the same ratio as the RIC's assets at month-end which are indexed assets bears to the value of all of the RIC's assets at month-end (the "indexed asset calculation"). A "safe harbor" in the bill would treat RIC shares as eligible for (a) 100 percent of any indexing adjustment for a particular month, if at least 90 percent of the RIC's assets were invested in indexed assets on the last day of the month, and (b) no inflation adjustment for that month, if 10 percent or less of the RIC's assets were invested in indexed assets at month-end. These provisions would apply to dispositions occurring after December 31, 1994. Today, the Institute filed the attached written statement in connection with the House Ways and Means Committee's recent hearing on the capital gains provisions in H.R. 9. In the statement, the Institute describes the computations that indexing would require and urges the following RIC-specific modifications: the bill's "safe harbor" should be modified so that (a) determinations of the extent to which RIC stock would be treated as an indexed asset are made quarterly rather than monthly and (b) the ratio of indexed assets to all assets is treated as being (1) 100 percent, if 80 percent or more of the RIC's portfolio is invested in indexed assets, and (2) zero, if 20 percent or less of the RIC's portfolio is invested in indexed assets; and the basis adjustments required for RIC shares when a RIC returns capital or retains capital gain should be made to an investor's oldest block(s) of shares first, rather than pro rata to all of the investor's RIC shares. The Institute's statement also urges a technical modification to the formula for computing the appropriate inflation adjustment

and urges certain modifications to the rules for applying indexing to investments in partnerships, such as partnerships which are master funds in a master-feeder structure. We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachments

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