

MEMO# 2348

November 28, 1990

EXPECTED ISSUANCE OF FINAL SECTION 852(B)(3)(C) POST-OCTOBER LOSS REGULATIONS

- 1 - November 28, 1990 TO: TAX MEMBERS NO. 51-90 ACCOUNTING/TREASURERS MEMBERS NO. 25-90 CLOSED-END FUND MEMBERS NO. 48-90 RE: EXPECTED ISSUANCE OF FINAL SECTION 852(b)(3)(C) POST-OCTOBER LOSS REGULATIONS

Background As you know, earlier this year the Internal Revenue Service issued temporary and proposed regulations under Code section 852(b)(3)(C) on the effect of a post-October capital loss and a post-October currency loss on a regulated investment company's ("RIC's") taxable income, its earnings and profits, and the amount that it may designate as a capital gain dividend for the taxable year in which the loss is incurred and the succeeding taxable year. (See Institute Memorandum to Tax Members No. 7-90, Closed-End Fund Members No. 7-90, and Accounting/Treasurers Members No. 6-90, dated February 1, 1990.) Among the provisions in these temporary regulations is one permitting RICs to make "retroactive elections" to defer post-October losses for any taxable year with respect to which a RIC filed its income tax return on or before May 1, 1990. To the extent that a retroactive election results in undistributed income for a prior year, the RIC may pay a "retroactive dividend." The deadline for making retroactive elections and paying retroactive dividends is December 31, 1990. Subsequently, the Institute filed a comment letter addressing three separate issues in the regulations. (See Institute Memorandum to Tax Committee No. 8-90, Closed-End Fund Committee No. 9-90 and Accounting/Treasurers Committee No. 11-90, dated April 2, 1990.) At present, the industry is faced with the dilemma of having to make retroactive elections and pay retroactive dividends by December 31, 1990 pursuant to the temporary regulations without knowing whether the changes suggested by the Institute will be adopted. Consequently, the Institute has been working with the Internal Revenue Service and the Treasury - 2 - Department to obtain prompt issuance of final regulations. We - 3 - believe that final regulations incorporating most of the Institute's suggested changes are in the last stages of review and could be released within the next few days. The Final Regulations The following is a summary of what we understand the final regulations will provide based on informal conversations with the IRS and Treasury. Although this summary should not be relied upon as definitive, we have alerted you at this time in light of the short time period remaining to make retroactive elections and pay retroactive dividends under the regulations. 1. The regulations will treat any decline in value of either a section 1256 contract or a straddle between October 31, when the contract or position is marked to market for excise tax purposes, and the end of the RIC's fiscal year, when the contract or position is marked to market for income tax purposes, as a post-October loss. 2. A deferred post-October loss will be treated as arising on the first day of the RIC's next fiscal year for

purposes of computing the capital loss carryforward period. 3. In determining the amount of the retroactive dividend to pay by December 31, 1990, RICs will be permitted to net prior year overdistributions and underdistributions arising from the election to defer post-October losses. Thus, for example, if a RIC elects to defer a \$200 post-October loss from FY 1987 to FY 1988 and that deferral causes an underdistribution in FY 1987 of \$6 and a \$200 overdistribution in FY 1988, the RIC may treat \$6 of the FY 1988 \$200 overdistribution as a retroactive dividend and receive a dividends paid deduction for an additional \$6 in FY 1987 without the necessity of distributing an additional \$6 in 1990 to shareholders. However, contrary to the Institute's request, the RIC would not receive a dividends paid deduction for the remaining overdistribution of \$194 either in 1989 or, if the RIC had fully distributed its 1989 income, in 1990. 4. The capital gain designation rules will be modified for the transition period to ensure that a retroactive election to defer post-October losses for taxable income purposes does not result in a RIC-level capital gains tax where the RIC previously distributed all of its earnings and profits. Thus, for example, if a calendar-year RIC had a \$200 long-term capital gain on August 1, a \$200 post-October loss, \$200 of investment company taxable income and distributed \$400, none of which it designated as a capital gain dividend, the election to defer the \$200 post-October loss would not result in a RIC-level tax on the \$200 capital gain realized on August 1 because the RIC would be permitted to retroactively designate \$200 of the \$400 distribution as a capital gain dividend. This retroactive designation would not, however, have any impact on the - 4 - shareholders' treatment of the income. 5. RICs that filed income tax returns on or before May 1, 1990 will be required to file amended tax returns for all years in which post-October losses are deferred and in all subsequent years affected by the deferral. Amended tax returns will be required even in situations where the original tax returns reflected the election to defer the losses. All such amended tax returns must be filed pursuant to the retroactive election procedure by December 31, 1990. 6. RIC shareholders need not be notified if the effect of a retroactive election is to change the character of any income previously distributed by the RIC to its shareholders. * * * * As soon as the final regulations are released, we will send them to you. Keith D. Lawson Associate General Counsel
Attachment KDL:bmb