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SERVING INDIVIDUAL INVESTORS
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TAX PROVISIONS IN CLINTON ADMINISTRATION'S FY 2000 BUDGET PROPOSAL

1 See Institute Memorandum to Tax Members No. 6-98 and International Members No. 4-98, dated February 9, 1998. 2 Note, however, that legislation introduced in July 1998, which was drafted with the intention of implementing generally the Treasury proposal, included an Institute suggestion that income derived from foreign bonds generally be exempt from U.S. withholding tax, so long as foreign tax (if any) with respect to the bonds is not reduced or eliminated by a treaty with the United States. Thus, under the July 1998 bill, no limit would have been placed on the ability of U.S. funds to invest in foreign securities, such as Euro bonds, that are free from foreign tax pursuant to foreign law. See Institute Memorandum to International Members No. 15-98 and Tax Members No. 21-98, dated July 14, 1998. [10695] February 3, 1999 TO: ACCOUNTING/TREASURERS MEMBERS No. 7-99 INTERNATIONAL MEMBERS No. 5-99 TAX MEMBERS No. 8-99 TRANSFER AGENT ADVISORY COMMITTEE No. 13-99 RE: TAX PROVISIONS IN CLINTON ADMINISTRATION'S FY 2000 BUDGET PROPOSAL

____ The Clinton Administration’s budget proposal for the fiscal year beginning October 1, 1999 includes several provisions of interest to regulated investment companies (“RICs”) and their shareholders. Many of the provisions discussed below previously have been proposed by the Administration. All of the attached proposal descriptions are from the Treasury Department’s “General Explanations of the Administration’s Revenue Proposals.” A. Withholding Tax Exemption for Certain Bond Fund Distributions (Attachment A) The Administration again1 has proposed to exempt from U.S. withholding tax all distributions made to foreign investors in certain bond funds. The proposal would apply to mutual fund taxable years beginning after the date of enactment. Specifically, the Treasury explanation provides that all income received by a U.S. mutual fund “that invests substantially all of its assets in U.S. debt securities or cash” would be treated as interest exempt from U.S. withholding tax when distributed to the fund’s foreign investors. A fund would be treated as meeting this “substantially all” test “if it also invests some of its assets in foreign debt instruments that are free from foreign tax pursuant to the domestic laws of the relevant foreign countries.” The Treasury explanation does not indicate what portion of a fund’s assets could be invested in foreign bonds without violating the “some” standard.2 3 See Institute Memorandum to Tax Committee No. 9-98, International Committee No. 12-98 and Transfer Agent Advisory Committee No. 17-98 (among others), dated March 13, 1998. 4 This proposal first was advanced by the Administration late in 1995. See Institute Memorandum to Tax Committee No. 4-96 and Transfer Agent Advisory Committee No. 5-96 (among others), dated January 25, 1996. 5 See e.g., Institute Memorandum to Tax

Committee No. 15-96, dated May 21, 1996, and the Institute Memorandum cited in footnote 3, supra. -- 2 -- The Institute previously has supported this Administration proposal as an important first step toward eliminating all U.S. tax incentives for foreign investors to prefer foreign funds over U.S. funds.3 The Institute's position on the Administration proposal remains unchanged. B. Mandatory Accrual of Market Discount (Attachment B) The Administration would modify significantly the taxation of market discount by eliminating the option taxpayers now have to defer the inclusion of any market discount into income until the debt instrument acquired with market discount is sold. Under the Administration's proposal, accrual basis taxpayers would be required to include market discount in income currently, i.e., as it accrues. The holder's yield for market discount accrual purposes would be limited to the greater of (1) the original yield-to-maturity of the debt instrument plus five percentage points or (2) the applicable Federal rate (at the time the holder acquired the debt instrument) plus five percentage points. The proposal would apply to debt instruments acquired on or after the date of enactment. C. Increased Penalties for Failure to File Correct Information Returns (Attachment C) The Administration again4 has proposed to increase the maximum penalty for failure to file correct information returns -- currently set at $50 per return -- to the greater of $50 per return or five percent of the aggregate amount required to be reported correctly (subject, in general, to a $250,000 cap). An exception to the increased penalty would apply, however, if the aggregate amount actually reported by the taxpayer on all returns filed for that calendar year was at least 97 percent of the amount required to be reported. The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment. The Institute previously has opposed this proposal because the current penalty structure provides powerful incentives for RICs to correct promptly any error made.5 D. 15-Year Amortization of Start-Up Expenses (Attachment D) The Administration also proposes to extend from 5 years to 15 years the amortization period provided by sections 195 and 248, respectively, for start-up and organizational expenses; this proposal would apply to expenditures incurred after the date of enactment. While small taxpayers could deduct up to $5,000 each of start-up and organizational expenditures in the year a trade or business begins, the 6 This proposal first was included in an Administration budget proposal in 1996. See Institute Memorandum to Tax Members No. 13-97 and Transfer Agent Advisory Committee No. 15-96 (among others), dated March 26, 1996. See also the Institute Memorandum cited in footnote 4, supra. 7 See, e.g., the Institute Memoranda cited at note 5, supra. -- 3 -- $5,000 amount would be reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures, respectively, exceeds $50,000. E. Partial Liquidation of Partnership Interests (Attachment E) The rules for partial liquidations of partnership interests would be modified under the Administration's budget proposal to treat (1) the partial liquidation of the entire partnership interest as (2) a complete liquidation of a portion of the partnership interest. Thus, a partial liquidation no longer would be treated as a nonrecognition event (unless the amount of money distributed exceeded the partner's basis in the partnership interest). Instead, the partial liquidation would be treated as a taxable disposition of that portion of the partnership interest. To illustrate, assume a feeder fund that holds a $100 million investment (with a cost basis of $80 million) in a master fund. Further assume that the feeder fund experiences net redemptions of $5 million and receives that amount in cash from the master fund. Under present law, the cash distribution attributable to the partial redemption reduces the feeder fund's cost basis in its partnership interest to $75 million. Under the Administration's proposal, the feeder fund would be treated as having disposed of a $5 million interest in the partnership with a gain of $1 million ($5 million proceeds less $4 million basis in the partnership interest). F. Conversions of Large C Corporations to S Corporations (Attachment F) The Administration again6 has proposed to repeal section 1374 for "large corporations" (i.e., any corporation with a value of more than $5 million). Under section 1374, corporations may convert tax- free from Subchapter C status to Subchapter S status, although the new "S" corporation remains subject to tax at the entity level to the extent that it recognizes built-in gain on any assets, held at the time of conversion, that are sold within 10 years of the conversion. The proposal to repeal section 1374 for large corporations would apply to Subchapter S elections first effective for a taxable year beginning after January 1, 2000 and to acquisitions (e.g., mergers) after December 31, 1999. While section 1374 does not apply to RICs, IRS Notice 88-19 provides that similar rules will apply to the conversion of a corporation to a RIC (or to a real estate investment trust ("REIT")). Consequently, the Administration's explanation indicates that IRS would revise IRS Notice 88-19 to conform to the proposed change to section 1374. Effective dates similar to those provided for section 1374 repeal would apply to any change to Notice 88-19. The Institute previously has urged that, should this proposal be enacted, the legislative history include a statement making it clear that the proposal would not impact IRS Notice 88-96. This notice provides a safe harbor from recognition of built-in gain for the situation in which a C corporation that previously was a RIC requalifies under Subchapter M following a temporary failure so to qualify.7 The Institute continues to hold this position. G. Constructive Ownership of Partnership Interests (Attachment G) -- 4 -- The Administration's budget proposal also would address an investment strategy whereby, according to the Treasury explanation, certain taxpayers have entered into derivative transactions designed to provide the taxpayer with the "economics" of an equity interest in a partnership without giving the taxpayer an actual ownership interest. These "constructive ownership" transactions, the Treasury asserts, are designed to provide taxpayers with income deferral and conversion of ordinary income and short-term capital gain into long-term capital gain. Specifically, the proposal would limit the amount of long-term capital gain that a taxpayer could recognize from a "constructive ownership" transaction with respect to a partnership interest by treating any gain in excess of the "net underlying long-term capital gain" as ordinary income. An interest charge would apply to the extent gain was recharacterized as ordinary income (by assuming that the ordinary income was earned ratably over the period of constructive ownership). Alternatively, taxpayers could elect mark-to-market treatment for constructive ownership transactions in lieu of applying the gain recharacterization and interest rules. The proposal would be effective for gains recognized on or after the date of first committee action. "Constructive ownership transactions" would be defined to include (1) holding a long position under a notional principal contract with respect to the partnership interest; (2) entering into a forward contract to acquire the partnership interest; (3) being the holder of a call option and the grantor of a put option with respect to the partnership interest and (4) entering into one or more transactions having substantially the same effect. "Net underlying long-term capital gain" with respect to a transaction would be the aggregate amount of capital gain that the taxpayer would have had from an actual ownership interest in the partnership during the period of the constructive ownership. H. Precluding Taxpayers From Taking Tax Positions Inconsistent with the Form of Their Transactions (Attachment H) The Administration's budget proposal also generally would preclude a corporate taxpayer from taking any position (on a tax return) that the Federal income tax treatment of a transaction is different from that dictated by its form if a "tax indifferent party" has a direct or indirect interest in such transaction. A "tax indifferent party" would be defined to include a foreign person, a tax-exempt organization and any domestic corporation with any loss or credit carryforward that is more than three years old. The proposal would be effective for transactions entered into on or after the date of first committee action. The proposal would not apply (1) if the taxpayer discloses the inconsistent position on its timely- filed Federal income tax return for the year in which the transaction was entered into; (2) to the extent provided in regulations, if reporting the substance of the transaction more clearly reflects the taxpayer’s income; or (3) to certain transactions (such as publicly-available securities lending and repurchase agreement transactions) identified in regulations. Moreover, nothing in the proposal would prevent IRS from asserting the substance-over-form doctrine or imposing any applicable penalties. I. Straddle Rules (Attachment I) The Administration’s budget proposal also would modify and clarify the straddle rules, effective for straddles entered into on or after the date of enactment. First, the definition of personal property (for straddle purposes) would be modified to include actively traded stock. Second, the proposal would “clarify” that a taxpayer holding an appreciated position in personal property cannot recognize currently any loss or deduct currently any expenses (including interest expenses) that are attributable to structured financial transactions that include a leg of the straddle. The Treasury explanation provides the example of a taxpayer holding an appreciated position in actively traded stock that enters into a prepaid or -- 5 -- collateralized forward contract to sell the stock. Under the proposal, the taxpayer would be required to capitalize all expenses associated with the forward contract. Keith D. Lawson Senior Counsel Attachment 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: 10695.
