

MEMO# 7362

October 24, 1995

STATUS OF 1995 TAX LEGISLATIVE PROPOSALS

1 A separate memorandum to Pension Members, Operations Committee, and Transfer Agent Advisory Committee describes various pension-related provisions, including proposals relating to individual retirement accounts. 2 See Institute Memoranda to Accounting/Treasurers Members No. 19-95, Closed-End Fund Committee No. 16-95, Federal Legislation Committee No. 15-95, Operations Committee No. 18-95, Pension Committee No. 7-95, Tax Committee No. 16-95 and Transfer Agent Advisory Committee No. 25-95, dated April 7, 1995; and to Tax Members No. 16-95, Accounting/Treasurers Members No. 15-95, Operations Members No. 14-95, Transfer Agent Advisory Committee No. 20-95 and Closed-End Fund Committee No. 10-95, dated March 17, 1995. October 24, 1995 TO: ACCOUNTING/TREASURERS MEMBERS No. 48-95 CLOSED-END FUND COMMITTEE No. 51-95 INTERNATIONAL COMMITTEE No. 32-95 OPERATIONS MEMBERS No. 42-95 TAX MEMBERS No. 43-95 TRANSFER AGENT ADVISORY COMMITTEE No. 51-95 UNIT INVESTMENT TRUST COMMITTEE No. 78-95 RE: STATUS OF 1995 TAX LEGISLATIVE PROPOSALS

As you know, Congress is developing a tax legislative package to include in the budget reconciliation bill for the fiscal year that began on October 1. This memorandum describes a number of tax provisions (that are not pension-related)¹ that Congress has considered this year. Anyone interested in obtaining additional information regarding these proposals may do so by calling Keith Lawson at (202) 326-5832 or Anne Barr at (202) 326-5837. Tax provisions under consideration that would affect regulated investment companies ("RICs"), certain other investment pools and their shareholders/investors are contained in one or more of the following three bills: The "Tax Fairness and Deficit Reduction Act of 1995" (H.R. 1215), which passed the House of Representatives in April 1995,² contains provisions from the "Contract with America" that was advanced last fall by Republican candidates for the House. H.R. 1215 is hereinafter referred to as the "House-passed bill." ³ See Institute Memoranda to Accounting/Treasurers Members No. 14-94, Closed-End Fund Members No. 14-94, International Members No. 3-94, Operations Members No. 22-94, Pension Members No. 14-94, Tax Members No. 23-94, Transfer Agent Advisory Committee No. 24-94 and Unit Investment Trust Members No. 20-94, dated May 17, 1994; and to Tax Members No. 65-92, Accounting/Treasurers Members No. 37-92, Closed-End Fund Members No. 37-92, Operations Members No. 37-92, Unit Investment Trust Members No. 50-92, International Members No. 22-92 and Transfer Agent Advisory Committee No. 58-92, dated October 8, 1992. ² The "Seven-Year Balanced Budget Reconciliation Act of 1995" (H.R. 2491), which was approved by the House Ways and Means Committee on September 19, 1995, includes, among other things, various "tax simplification" provisions that have been included in prior "tax simplification" bills³. H.R. 2491 is hereinafter referred to as the "Ways and Means bill." The "Revenue Reconciliation Act of 1995" (Title XII of the Senate's budget reconciliation

bill), which was approved by the Senate Finance Committee on October 19, 1995, contains numerous provisions of interest to the industry, many of which are in one or the other of the two House bills. This legislation is hereinafter referred to as the "Senate bill." Any provision included in at least one of these three bills is expected to be eligible for inclusion in Congress' budget reconciliation bill.

I. Mutual Fund Tax Simplification

A. Repeal of the 30 Percent Test The Ways and Means bill would repeal the 30 percent test of Internal Revenue Code section 851(b)(3) for taxable years ending after date of enactment.

B. Tax-Free Conversions of Bank Common Trust Funds into RICs The Senate bill would permit a bank common trust fund meeting a modified diversification standard to transfer substantially all of its assets to one or more RICs in a tax-free exchange. The common trust fund must transfer its assets to the RIC(s) solely in exchange for shares of the RIC(s) and the common trust fund must then distribute the RIC shares to its participants in exchange for the participants interests in the fund. The proposal would be effective for transfers on or after January 1, 1996.

C. Cost Basis Reporting We are pleased to report that none of the three bills includes a proposal to require mutual funds and brokers to provide their shareholders/customers and the Internal Revenue Service ("IRS") with average cost information for redeemed fund shares. In deciding not to include a cost basis reporting provision in its 1995 tax simplification package, the House Ways and Means Committee effectively adopted the position taken by the Institute in its testimony.⁴ See Institute Memorandum to Tax Committee No. 28-95, dated July 27, 1995.

⁵ Each bill also would provide a maximum tax rate (25% in the House-passed bill and 28% in the Senate bill) on capital gains realized by corporations.

⁶ For a detailed discussion of this indexing proposal, see the Institute's March 17, 1995 memorandum that is discussed in footnote 2, above.

³ before the Committee in July that market competition has eliminated the need for legislation mandating the reporting of cost basis information.

4 **II. Capital Gains Provisions**

A. 50 Percent Capital Gains Deduction for Individuals The House-passed bill and the Senate bill permit individuals to deduct from income 50 percent of their net long-term capital gains (i.e., on assets held for more than one year).⁵ Under both bills, the benefit of this 50 percent deduction would flow through a RIC to its shareholders. A significant difference between these bills is that, while the House-passed bill would apply to dispositions on or after January 1, 1995, the Senate bill would apply only to dispositions after October 13, 1995. Under both bills, gains realized by a RIC and distributed to its shareholders would be eligible for the 50 percent deduction based upon the date each asset was sold rather than upon the date the distribution was made.

B. Indexing Cost Basis for Inflation The proposal to permit certain taxpayers to increase or "index" for inflation the cost basis of certain capital assets is contained only in the House-passed bill.⁶ A proposal that appeared in a Senate Finance Committee staff "discussion draft" of the Senate bill -- that would have given individuals an asset-by-asset option, with respect to certain assets (including certain RIC shares), to either deduct from income 50 percent of the assets capital gain or index the assets cost basis for inflation -- was not included in the bill approved by the Senate Finance Committee.

C. 50 Percent Exclusion For Certain Qualified Small Business Stock The House bill would repeal a provision in current law (applicable to RIC shareholders on a "look-through" basis) that allows individuals to exclude from income, up to certain limits, 50 percent of the gain on "qualified small business stock" that is purchased at original issuance (at which time the corporations assets did not exceed \$50 million) and held for at least 5 years. The Senate bill would retain the provision and modify it so that: (1) the taxable portion of any qualified small business stock gain realized by individuals would be eligible for the 50 percent capital gains deduction contained in the Senate bill (resulting in the qualified small business stock exclusion increasing from 50 percent to 75 percent); (2) gains attributable to qualified small business stock held for more than 5 years by corporations would be subject to tax at a maximum rate of 21 percent, rather than the

Senate bill's generally-applicable 28 percent maximum rate; (3) the maximum size of a corporation eligible for "qualified small business stock" status would increase from \$50 million to \$100 million; (4) the limitations on the amount of an individual's gain eligible for the 50 percent exclusion would be eliminated; and (5) individuals would be allowed to defer (or "roll over") gain from the disposition of qualified small business stock otherwise eligible for the 50 percent exclusion if other qualified small business stock is purchased with the proceeds within 60 days of the original sale. The effective date of the House bill's repeal provision would be retroactive to the original enactment of the provision, as if the qualified small business stock provision had never been enacted. The Senate bill's relaxation of the provision limiting the size of eligible corporations (from \$50 million to \$100 million) would apply to stock issued after date of enactment. The Senate bill's extension of certain qualified small business stock benefits to corporate holders would apply to stock acquired on or after date of enactment. All other Senate-bill modifications would apply to stock issued after August 10, 1993 (the original effective date of the provision).

III. Foreign Investment Provisions

A. Simplified Foreign Tax Credit Reporting The Ways and Means bill would allow individuals with no more than \$200 of creditable foreign taxes (\$400 in the case of a joint return) and no other foreign source income to elect a simplified method of claiming the foreign tax credit, effectively eliminating the need to file IRS Form 1116 (Computation of Foreign Tax Credit) with the individual income tax return. The provision would apply to taxable years beginning after December 31, 1995.

B. Passive Foreign Investment Companies The Ways and Means bill would modify the passive foreign investment company ("PFIC") rules to provide every taxpayer that holds "marketable" PFIC stock with an election to mark that stock to market at the close of the taxpayer's taxable year. Once made, the mark-to-market election would apply with respect to that stock for all subsequent years, unless the IRS consented to a revocation of the election. The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1995, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons. All PFIC stock held by open-end RICs (and by closed-end RICs, except as provided by regulation) would be treated as marketable stock. One RIC-specific PFIC rule that is not contained in the Ways and Means proposal -- but was contained in prior tax simplification bills -- would provide RICs with mark-to-market treatment at October 31 for purposes of the excise tax minimum distribution requirements of Code section 4982. Under the Ways and Means bill, any PFIC mark-to-market gain would be treated as ordinary income. PFIC mark-to-market losses would be allowable as an ordinary loss to the extent of net mark-to-market gains previously included with respect to such stock. The bill further provides that the nondeductible "interest charge" that would otherwise be imposed on a RIC that held PFIC stock prior to the effective date of the statute will not be imposed if the RIC had elected mark-to-market treatment (presumably under proposed regulations previously issued by IRS) for the prior taxable year.

IV. Common Investment Funds For Certain Foundations The Senate bill would amend the tax-exempt organization rules of Code section 501 to generally treat an organization comprised solely of at least 20 tax-exempt private foundations and/or community foundations as tax-exempt itself, so long as the organization is organized and operated solely to collectively invest in stocks and securities on behalf of its members. The proposal would be effective for taxable years ending after December 31, 1995.

V. Financial Asset Securitization Investment Trusts ("FASITs") The Senate bill would create a new type of entity, called a financial asset securitization investment trust ("FASIT"), for the securitization of certain debt obligations such as credit card receivables, home equity loans and auto loans. Interests in a FASIT would be limited to (1) a single "ownership interest," which could be held only by a single taxable domestic corporation (which would preclude RICs from holding ownership interests), and (2) "regular interests," which could be held by the general public (including RICs) and would be treated generally as debt obligations of

the FASIT. This proposal would be effective on date of enactment. An entity could not qualify as a FASIT unless, among other things, it (1) elected FASIT status (which could not be elected if the entity registered under the Investment Company Act of 1940), (2) limited substantially all of its assets to "permitted assets" (such as certain debt instruments) and (3) limited its investment activities (including the disposition of assets) in certain ways. In addition, if a FASIT were to issue "regular interests" that yielded interest in excess of a prescribed rate, these "regular interests" would be deemed "high-yield interests" that could be held generally only by those corporations eligible to hold ownership interests (e.g., not RICs). A FASIT generally would not be taxable. Instead, the FASIT's taxable income or net loss would flow through to its owner and would be taxed, in many ways, as if the FASIT owner were a partner in a partnership (although certain significant differences would arise). Holders of FASIT regular interests generally would be taxed like holders of any other debt instrument, except that they would be required to take interest income into account under the accrual method of accounting. In addition, holders of high-yield interests could not use net operating losses to offset any income derived from the high-yield interests. VI. Taxpayer Bill of Rights Provisions A. Contact Person on Tax Information Statements The Ways and Means bill would require that information statements sent to payees (such as IRS Forms 1099) include the name, address and telephone number of the payors "information contact." The Committee's explanation of the provision, incorporating an Institute proposal, indicates that the phone number of the department with the relevant information may be provided. The proposal would be effective for statements required to be furnished after December 31, 1996. B. Fraudulent Filing of Information Returns The Ways and Means bill would permit the recovery of civil damages from a party who "willfully files a fraudulent information return." This provision incorporates an Institute proposed modification to an earlier version of this proposal, which would have provided civil damages for "false or fraudulent" information returns. The Ways and Means proposal would be effective for fraudulent information returns filed after the date of enactment. * * * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax