

**MEMO# 9759**

March 16, 1998

## **DRAFT SUBMISSION ON CAPITAL GAINS ISSUES (IRS NOTICE 97-64)**

1 See Institute Memorandum to Tax Members No. 45-97 (among others), dated November 12, 1997. While IRS originally may have anticipated issuing capital gains guidance during 1998, the 1998 IRS Business Plan states that this guidance is not expected to be published until 1999. See Institute Memorandum to Tax Committee No. 8-98 (among others), dated March 4, 1998. 2 See Institute Memorandum to Tax Members No. 27-97 (among others), dated August 1, 1997. [9759] March 16, 1998 TO: TAX COMMITTEE No. 10-98 RE: DRAFT SUBMISSION ON CAPITAL GAINS ISSUES (IRS NOTICE 97-64)

The attached draft Institute memorandum has been prepared for submission to IRS on Notice 97-64,<sup>1</sup> relating to changes made by the Taxpayer Relief Act of 1997 to the capital gains rules. As discussed at the February Tax Committee meeting, the Institute's comments will address the following four general subjects. 1. Issues Relating to the "Bifurcation Adjustment" Described in the Notice. The Institute's draft submission recommends several clarifications/modifications to the "bifurcation adjustment" described in the Notice. In particular, we recommend that: (a) IRS clarify that the bifurcation adjustment applies for both designation purposes and taxable income purposes; (b) capital loss carryovers be deemed to arise on the first day of the taxable year to which they are carried; and (c) bifurcation not apply if the RIC has no post-October loss in any category. This last recommendation would help ensure that bifurcation applies only where necessary to "protect" the character of capital gain distributions made for excise tax purposes. 2. Recharacterization of Loss Under Section 852(b)(4)(A). Second, we recommend that any short-term loss recharacterized under section 852(b)(4)(A) as a "long-term" loss be treated as a 20 percent rate loss. This recommendation avoids the difficulties that would arise for shareholders under any approach that attempts to recapture the specific types of long-term gain included in the capital gain dividend. 3. Interaction of Sections 1259 and 4982. Third, we recommend that IRS regulations (a) clarify that the constructive sale rules of section 1259 (including the closed transaction exception) apply on the basis of a RIC's taxable (fiscal) year only and (b) provide, to any RIC seeking certainty as to the includability of constructive sale income for excise tax purposes, an election not to apply the closed transaction exception. In particular, we recommend that this election be made transaction by transaction and documented on an excise tax return for the period during which the income subject to the election arises. Any RIC making this election out of the closed transaction exception for a particular constructive sale would have income for excise tax and income tax purposes as of the date the constructive sale was entered into. 4. Additional Technical Modifications to Improve the Interaction Between the RIC Income Tax and Excise Tax Regimes. Finally, we recommend the so-called "glitch fixes" to resolve long-standing technical issues arising from the interaction between the income tax and excise

tax regimes. The glitch fixes address issues attributable to: (a) post-December ordinary losses; (b) pre-January ordinary losses; (c) the automatic deferral of post-October losses for dividend designation purposes; (d) post-October net short-term capital losses; (e) ordinary income and loss on dispositions of capital assets; and (f) application of the post-October loss rules to RICs exempt from section 4982. Action Requested Please review the attached draft memorandum and provide any comments to the undersigned by April 6, 1998. Comments may be submitted by phone (to 202-326-5832), by fax (to 202-326-5841), or by e-mail (to lawson@ici.org). Thank you. Keith D. Lawson Senior Counsel Attachment

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