

MEMO# 10400

October 22, 1998

CAPITAL GAINS TECHNICAL CORRECTION AND INTERNET TAX MORATORIUM INCLUDED IN APPROPRIATIONS ACT

1 H.R. 4328, the Omnibus Consolidated and Emergency Supplemental Appropriations Act. 2 The 20 percent maximum rate is reduced to 10 percent for taxpayers in the 15 percent rate bracket. In addition to 20 percent/10 percent rate gain, some RICs may have "collectibles gain" that remains taxable at a 28 percent maximum rate and/or "unrecaptured section 1250 gain" that remains taxable at a 25 percent maximum rate. 3 See Institute Memorandum to Tax Members No. 18-98, Accounting/Treasurers Members No. 16-98, Operations Members No. 17-98, Closed-End Investment Company Members No. 19-98, Unit Investment Trust Members No. 14-98, International Members No. 13-98, Transfer Agent Advisory Committee No. 33-98 and Broker/Dealer Advisory Committee No. 10-98, dated June 26, 1998. [10400] October 22, 1998 TO: ACCOUNTING/TREASURERS MEMBERS No. 31-98 CLOSED-END INVESTMENT COMPANY MEMBERS No. 38-98 OPERATIONS MEMBERS No. 29-98 TAX MEMBERS No. 36-98 TRANSFER AGENT ADVISORY COMMITTEE No. 70-98 UNIT INVESTMENT TRUST MEMBERS No. 29-98 RE: CAPITAL GAINS TECHNICAL CORRECTION AND INTERNET TAX MORATORIUM INCLUDED IN APPROPRIATIONS ACT

We are please to inform you that the Appropriations Act¹ signed into law yesterday by President Clinton contains two provisions sought by the Institute. First, the Appropriations Act modifies the capital gains holding period rules so that essentially all RIC capital gain dividends paid to shareholders during 1998 will be taxed at a maximum rate of 20 percent.² Second, the Act establishes a temporary moratorium on the imposition of certain state and local taxes on Internet access and electronic commerce. I. CAPITAL GAINS (Attachment A) A. Background As we previously informed you, the Internal Revenue Service Restructuring and Reform Act of 1998 (the "1998 Restructuring Act")³ modified the taxation of capital gains by reducing from more than 18 months to more than one year the holding period requirement for the 20 percent maximum capital ⁴ See Institute Memorandum to Tax Members No. 27-97, Accounting/Treasurers Members No. 31-97, Operations Members No. 13-97, International Members No. 12-97, Closed-End Investment Company Members No. 23-97, Unit Investment Trust Members No. 28-97 and Transfer Agent Advisory Committee No. 36-97, dated August 1, 1997. ⁵ If the RIC in 1998 also distributed gain on assets that were held for more than one year and sold after May 6, 1997 and before July 29, 1997, the gain also would be taxable at a 20 percent maximum rate. ⁶ For example, if a RIC received a REIT capital gain dividend in 1998 that is attributable to an asset held by the REIT for between 12 and 18 months that the REIT sold on November 15, 1997, the RIC could treat the gain as a 20 percent rate gain if it were distributed to the RIC shareholders in 1998 as part of a capital gain distribution. ⁷ For example, gain on an asset

sold on November 15, 1997 by a qualified partnership master fund, after being held by the master fund for 15 months, would be eligible for 20 percent rate treatment if distributed by a feeder- fund RIC to its shareholders after December 31, 1997. gains rate that was enacted as part of the Taxpayer Relief Act of 1997 ("the 1997 Act").⁴ Under the 1998 Restructuring Act: (1) any gain on the disposition after 1997 of RIC shares held for more than one year is taxed at a 20 percent maximum rate; (2) any portion of a RIC capital gain dividend paid after 1997 also is taxable at a 20 percent maximum rate if the asset was sold by the RIC: (a) after December 31, 1997; or (b) after July 28, 1997 and before January 1, 1998 and held for more than 18 months;⁵ but (3) prior to modification by the Appropriations Act, any portion of a RIC capital gain dividend paid after 1997 that was attributable to long-term gain on RIC assets sold: (a) before May 7, 1997; or (b) after July 28, 1997 and before January 1, 1998 (but not held by the RIC for more than 18 months); would have remained taxable at a 28 percent maximum rate. B. General Application of the Technical Correction Under the Appropriations Act, 20 percent rate treatment also applies to the portion of a RIC capital gain dividend paid after 1997 that is attributable to assets sold after July 28, 1997 and before January 1, 1998 (after being held for more than one year but not more than 18 months) where the gains (and any offsetting losses) are: (1) recognized directly by the RIC; (2) properly taken into account by the RIC, by reason of holding (directly or indirectly) an interest in another RIC or in a REIT, to the extent that such amounts are eligible for 20 percent rate treatment under the Appropriations Act;⁶ and (3) recognized by the RIC from a "qualified partnership," which is defined to include an investment by a RIC in a "master fund" in the master-feeder fund structure.⁷ 8 See Institute Memoranda to Tax Members No. 11-98 and Electronic Commerce Issues Working Group, dated April 7, 1998; to Tax Members No. 19-98 and Electronic Commerce Issues Working Group, dated July 10, 1998; and to Tax Members No. 26-98 and Electronic Commerce Issues Working Group, dated August 25, 1998. - 3 - C. Treatment of Investments in Partnerships Gains recognized by the RIC from an investment in a partnership with a taxable year ending in 1997 will not be eligible for this extended 20 percent rate treatment unless the investment is in a "qualified partnership." Under the Act, a partnership is a "qualified partnership" with respect to a RIC if: (1) the partnership is an investment company registered under the Investment Company Act of 1940 (the "1940 Act"); (2) the RIC is permitted to invest in such partnership by reason of section 12(d)(1)(E) of the 1940 Act or an SEC exemptive order under such section; and (3) the RIC and the partnership have the same taxable year. Other requirements that must be met for the technical correction to apply to gains from a partnership include requirements that: (1) as of January 1, 1998, either: (a) at least 35 percent of the RIC's total assets are in one qualified partnership; or (b) at least 90 percent of the RIC's total assets are invested in more than one qualified partnership; (2) the partnership recomputes its gains and losses applying the technical correction; and (3) the partnership provides the RIC with written documentation of its distributive share as so redetermined. II. INTERNET TAX MORATORIUM (Attachment B) To address concerns that taxes imposed by state and local governments could threaten the continued growth of the Internet and electronic commerce, the Appropriations Act places a temporary moratorium on certain state and local taxes relating to Internet activities. As you may know, various proposals for a moratorium have been under consideration this year.⁸ The Appropriations Act establishes a three-year moratorium (beginning October 1, 1998 and ending three years after the enactment of the Appropriations Act) on the following state and local taxes: (1) taxes on Internet access; and (2) "multiple" and "discriminatory" taxes on electronic commerce. The legislation provides that the moratorium on Internet access taxes will not apply to existing taxes that were "generally imposed and actually enforced prior to October 1, 1998." Exceptions to the moratorium also provided in situations involving materials that are harmful to minors. - 4 - An Advisory Commission on

Electronic Commerce will be created to study federal, state and local, and international taxation and tariff treatment of transactions using the Internet, Internet access, and other comparable intrastate, interstate or international sales activities. The Commission must issue a report to Congress on the study within 18 months. The legislation also states that it is the sense of Congress that (1) no new federal Internet-related taxes should be enacted during the moratorium, and (2) the President should seek agreements through various international organizations to remove barriers to global electronic commerce. III.

TREATMENT OF CERTAIN DEDUCTIBLE REIT/RIC LIQUIDATING DISTRIBUTIONS (Attachment C)

The Appropriations Act also addresses a transaction that was entered into by certain REITs that were owned at least 80 percent by one corporate shareholder; in this transaction, the REIT would liquidate and receive a deduction for certain amounts paid to its parent, but without a corresponding inclusion of income to the parent. Because both REITs and RICs may take a dividends paid deduction for amounts distributed in liquidation that are properly chargeable to earnings and profits, the provision also applies to 80-percent-owned RICs. Under the Appropriations Act, any amount for which a liquidating REIT or RIC may take a dividends paid deduction, with respect to an otherwise tax-free liquidating distribution to an 80-percent corporate owner, is includable in the recipient corporation's income as a dividend. The provision applies to distributions made on or after May 22, 1998, regardless of when the plan of liquidation was adopted. The provision has no other effect on the tax treatment of the distribution to the parent corporation or to the REIT or RIC. Thus, for example, the liquidating REIT or RIC does not recognize gain (if any) on the liquidating distribution and the recipient corporation holds the distributed assets at a carryover basis. Keith D. Lawson Anne M. Barr Senior Counsel Associate Counsel

Attachments 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: 10400.