

**MEMO# 1481**

October 24, 1989

## **SENATE APPROVES TAX PROVISIONS IN OMNIBUS RECONCILIATION ACT OF 1989 (ORA)**

October 24, 1989 TO: TAX MEMBERS NO. 42-89 CLOSED-END FUND MEMBERS NO. 61-89  
UNIT INVESTMENT TRUST MEMBERS NO. 58-89 ACCOUNTING/TREASURERS COMMITTEE NO.  
46-89 OPERATIONS COMMITTEE NO. 21-89 TRANSFER AGENT SHAREHOLDER ADVISORY  
COMMITTEE NO. 27-89 RE: SENATE APPROVES TAX PROVISIONS IN OMNIBUS  
RECONCILIATION ACT OF 1989 (ORA)

The Senate recently approved certain revenue reconciliation provisions in the Omnibus Reconciliation Act of 1989 (ORA). Earlier, the House accepted the revenue reconciliation provisions previously approved by the House Ways and Means Committee. (See Institute Memorandum to Tax Members No. 32-89, Closed-End Fund Members No. 43-89, Unit Investment Trust Members No. 49-89, Accounting/Treasurers Committee No. 38-89, Operations Committee No. 17-89, and Transfer Agent Shareholder Accounting Advisory Committee No. 24-89, dated September 27, 1989.) The following is a summary of the provisions of the bill which affect regulated investment companies ("RICs") and their shareholders. The relevant portions of the bill and the Senate Finance Committee Report are attached.

I. PHANTOM INCOME No provision regarding phantom income (section 67(c)) is included in the bill. As we previously informed you, when Congress enacted the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) last year, it intended to postpone imposition of the phantom income tax on publicly-offered RICs until 1990. However, the enacted TAMRA language both delayed the application of section 67(c) to publicly-offered RICs until 1990 and repealed section 67(c) entirely for taxable years beginning after 1989. (See Institute Memorandum to Tax Members No. 59-88, Closed-End Fund Members No. 55-88, Unit Investment Trust Members No. 69-88 and Accounting/Treasurer Advisory Committee No. 41-88, dated November 14, 1988.) This year, during its deliberation of the tax bill, the Senate Finance Committee determined that section 67(c) should continue to apply to taxpayers other than publicly-offered RICs but that publicly-offered RICs should be permanently exempted from the application of section 67(c). However, it is our understanding that language implementing the Committee's discussion was inadvertently left out of the Finance Committee bill and the accompanying Committee Report. Consequently, no special provision regarding phantom income is included in the bill.

II. RIC-SPECIFIC PROVISIONS

1. Section 4982 Ordinary Income Distribution Requirement (Attachment 1). The bill would increase the section 4982 minimum distribution requirement for ordinary income from 97 percent to 98 percent. This amendment would apply to calendar years ending after July 10, 1989.
2. Sales Load Basis Deferral (Attachment 2). Section 852 would be amended by the bill to require any shareholder who purchased shares in one RIC (RIC "A"), and transferred all or part of that

investment to a second RIC in the same investment company complex (RIC "B"), to exclude from the basis of any RIC "A" shares that were disposed of within six months from the purchase date (30 days in the House bill) the sales load incurred on those shares to the extent that the sales load on the RIC "B" shares was reduced because a load had previously been paid on the RIC "A" shares. Any sales charge not included in the basis of RIC "A" shares would be treated as incurred to acquire the RIC "B" shares. This amendment would apply to sales loads incurred after October 3, 1989 in taxable years ending after such date.

3. Dividend Accrual on Ex-dividend Date (Attachment 3). The bill would amend section 852(b) to require a RIC to treat any dividend it receives as received on the later of (i) the date the stock owned by the RIC became ex-dividend with respect to such dividend, or (ii) the date the RIC acquired such stock.

III. RIC-RELATED PROVISIONS

4. Applicable High Yield Discount Obligations (Attachment 4). The Senate bill would substantially modify the treatment provided in the House bill for any "applicable high yield discount obligation," i.e., any debt instrument (1) with a maturity date of more than 5 years from the date of issue, (2) with a yield to maturity that equalled or exceeded the sum of the applicable Federal rate for the calendar month in which the obligation was issued plus 5 percentage points, and (3) which had "significant original issue discount." Under the House bill, "disqualified discount obligations" would be treated as preferred stock, both for purposes of the issuer and the holder of such an instrument. Under the Senate bill, a Subchapter C corporation would not be permitted to deduct any portion of original issue discount on an "applicable high yield discount obligation" until such portion was actually paid. No change would be made to the requirement that the holder of such an obligation (such as a RIC) include such interest in income as it accrues. This provision would be effective generally for instruments issued after July 10, 1989. An assumption by a taxpayer of an instrument issued by another taxpayer would be treated as a new issuance for purposes of this rule. The effective date rule would, however, be subject to exceptions, including one which would exempt from the rule instruments issued pursuant to the terms of a debt instrument that was issued before the effective date, such as a payment-in-kind ("PIK") bond issued after July 10, 1989 as interest on a PIK bond issued before July 10, 1989.

5. Disqualified Preferred Stock (Attachment 5). The bill would also amend section 1059 to treat as an extraordinary dividend any dividend with respect to "disqualified preferred stock," i.e., a stock which (1) when issued, had a dividend rate which declined (or could reasonably be expected to decline) in the future, (2) had an issue price that exceeded its liquidation rights or its stated redemption price, or (3) was otherwise structured to avoid the other provisions of section 1059 and to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock. The provision is not intended to apply to preferred stock dividends where the declining dividend rate is due to an unforeseen economic downturn in the issuer's business or to dividends on floating rate or auction rate preferred stock whose dividend rate declines solely in response to market changes. Treatment of a dividend as extraordinary would result in a reduction in a corporate shareholder's basis in its stock by the portion of the dividend eligible for the dividends received deduction. This amendment would apply generally to stock issued after July 10, 1989.

6. Debt/Equity Regulatory Authority (Attachment 6). The bill would clarify the Treasury Department's regulatory authority under section 385 to treat an instrument as part stock and part debt. This authority would apply prospectively only with respect to instruments issued after public guidance was released.

7. Dividends Paid by Members of Consolidated Group (Attachment 7). Section 246 would be amended by the bill to disallow the dividends received deduction ("DRD") in certain circumstances for distributions made (i) by a member of an affiliated group of corporations filing a consolidated return to a nonmember shareholder, such as a RIC, (ii) with respect to stock described in section 1504(a)(4) (generally, nonvoting preferred stock that does not participate in corporate

growth to any significant extent). The amount of dividends with respect to which the DRD would be disallowed would be determined by applying a formula that would compare the amount of certain losses and credits of other members of the affiliated group with the separately computed taxable income of the corporation paying the dividend. The Committee Report indicates that this amendment is proposed because, under present law, the consolidated group may in effect sell the benefit of its consolidated net operating losses or credits through the availability of the dividends received deduction for distributions to minority shareholders. The House bill took a different approach with regard to dividends paid by members of a consolidated group. As we previously informed you, the House bill would amend section 1503 to require that any distribution made by a member of an affiliated group of corporations filing a consolidated return to a nonmember shareholder, such as a RIC, be treated as a dividend only to the extent that the consolidated group as a whole, and not the corporation paying the dividend, had earnings and profits. The Senate bill provision would be generally effective for distributions after October 2, 1989. Subject to certain exceptions, however, the provision would not apply to dividends with respect to subsidiary stock issued on or before that date.

8. Reduction in Built-In Loss Threshold (Attachment 8). The bill would restrict the use of built-in losses for purposes of the section 382 limitation on net operating loss carryforwards and, by cross-reference, the section 383 limitation on capital loss carryforwards. Under present law, these limitations apply only if the net unrealized built-in loss exceeds 25 percent of the fair market value of the corporation's assets. Under the Senate bill, these limitations would apply if the net unrealized built-in loss exceeded the lower of (1) 15 percent of the fair market value of the corporation's assets or (2) \$25 million (\$10 million in the House bill). This Senate bill provision would be generally effective for ownership changes and acquisitions after October 2, 1989 in taxable years ending after such date.

IV. HOUSE BILL PROVISIONS EXCLUDED FROM SENATE BILL Several provisions included in the House bill (such as capital gains rate reductions/indexing, civil tax penalty reform and technical corrections) are not included in the Senate bill. Many of these provisions (or alternative proposals) were originally included in the bill reported by the Senate Finance Committee. The bill the Senate has sent to the Conference Committee, however, is "stripped down" essentially to provisions which raise the money needed to satisfy Gramm-Rudman-Hollings requirements. \* \* \* \* \*

We will keep you informed of developments. Keith D. Lawson Assistant General Counsel Attachments