INVESTMENT COMPANY INSTITUTE

MEMO# 10135

July 17, 1998

CONGRESS PASSES BILL WITH ROTH IRA TECHNICAL CORRECTIONS AND CAPITAL GAINS HOLDING PERIOD CHANGE; 1998 CAPITAL GAINS REPORTING PROBLEM CREATED FOR FUND SHAREHOLDERS

[10135] July 17, 1998 TO: BOARD OF GOVERNORS No. 46-98 FEDERAL LEGISLATION MEMBERS No. 16-98 PRIMARY CONTACTS - MEMBER COMPLEX No. 64-98 PUBLIC INFORMATION COMMITTEE No. 29-98 RE: CONGRESS PASSES BILL WITH ROTH IRA TECHNICAL CORRECTIONS AND CAPITAL GAINS HOLDING PERIOD CHANGE; 1998 CAPITAL GAINS REPORTING PROBLEM CREATED FOR FUND SHAREHOLDERS ____ The Senate last week approved the conference report on H.R. 2676, a bill that would primarily restructure the Internal Revenue Service, but that also contains important technical corrections, expands eligibility for Roth IRAs and reduces the capital gains holding period. Significantly, the bill reduces the top tax rate on most long-term capital gains to 20 percent, but with an effective date that, as discussed below, will force some mutual fund shareholders (and some other investors) to report part of their capital gain dividends received in 1998 as 28 percent rate gain and in part as 20 percent rate gain. The House approved the conference report last month, so the Senate action clears the bill to be sent to the President, who has indicated he will sign the bill. The technical corrections portion of the bill includes provisions designed to clarify several issues relating to Roth IRA conversions, Education IRAs, distributions from IRAs and qualified plans, capital gains and U.S. investments in foreign securities. Another provision of the bill would expand the eligibility of persons 70½ or older to convert regular IRAs to Roth IRAs. Beginning in 2005, such persons would not have to include minimum required IRA distributions in their income when determining if they are eligible to make the conversion. The bill also reduces from 18 months to 12 months the required holding period for 20 percent maximum capital gains rate treatment. The new 12-month holding period requirement applies, in the case of a mutual fund’s capital gain dividend, only to assets sold by the fund during 1998. Consequently, gains on assets held by the fund for between 12 and 18 months that were sold during 1997 remain taxable at a 28 percent maximum rate, even if distributed in 1998. Thus, for 1998 only, some shareholders will receive capital gain dividends that are taxable in part at 28 percent (because they relate to assets sold in 1997) and in part at 20 percent. The 28 percent and 20 percent portions of these gains will be reported separately on the Schedule D that is attached to individual income tax returns. We believe this to be an inadvertent outcome, not intended by the authors of the legislation. The Institute is seeking

a modification that will eliminate this 1998 reporting problem for fund shareholders. We will keep you informed of developments. Matthew P. Fink President

---