

MEMO# 10829

March 24, 1999

INSTITUTE STATEMENTS ON ADMINISTRATION'S TAX PROPOSALS AND INTERNATIONAL TAX REFORM

1 See Institute Memorandum to Accounting/Treasurers Members No. 7-99, International Members No. 5-99, Tax Members No. 8-99 and Transfer Agent Advisory Committee No. 13-99, dated February 3, 1999. 2 A separate memorandum to the Pension Committee discusses the retirement security issues. [10829] March 24, 1999 TO: ACCOUNTING/TREASURERS COMMITTEE No. 9-99 INTERNATIONAL COMMITTEE No. 11-99 TAX COMMITTEE No. 5-99 TRANSFER AGENT ADVISORY COMMITTEE No. 22-99 RE: INSTITUTE STATEMENTS ON ADMINISTRATION'S TAX PROPOSALS AND INTERNATIONAL TAX REFORM

The Institute has submitted to Congress the attached two written statements in connection with recent legislative hearings. The first attached statement was filed today with the House Ways and Means Committee in connection with a hearing on the Clinton Administration's Fiscal Year 2000 budget proposal.¹ This written statement, summarized below, sets forth the Institute's position on several tax and retirement security provisions of interest to regulated investment companies ("RICs") and their shareholders.² The second attached statement was filed with the Senate Finance Committee in connection with a hearing on international tax reform. This written statement urges enactment of "investment competitiveness" legislation that would eliminate U.S. withholding tax incentives for foreign investors to prefer foreign funds over U.S. funds, by permitting interest and short-term gains to "flow through" a fund to its foreign investors. (1) Withholding Tax Exemption for Certain Bond Fund Distributions. The Administration has proposed again to exempt from U.S. withholding tax distributions to foreign investors in certain bond funds. The Institute's statements filed with the House Ways and Means and Senate Finance Committees urge enactment of broader "flow-through" legislation. Specifically, the Institute urges enactment of legislation that would permit all U.S. funds -- equity, balanced and bond funds -- to preserve, for U.S. withholding tax purposes, the character of interest income and short-term capital gains distributed to foreign investors, provided that the income and gains would be exempt from U.S. withholding tax if received directly or through a foreign fund. The statements further urge that any "flow-through" legislation limited to bond funds (such as along the lines proposed by the Administration) place no limit on the ability of U.S. funds to hold foreign bonds (such as "Eurobonds") that are free from foreign tax in the hands of a U.S. investor pursuant to the domestic law of the relevant foreign countries. (2) Mandatory Accrual of Market Discount. The Administration has proposed to require accrual basis taxpayers, including RICs, to currently include market discount in income. The Institute has urged that this proposal be rejected because its effects -- accelerated inclusion of market discount in

3 To illustrate, assume a feeder fund partner that holds a \$100 million

investment (with a cost basis of \$80 million) in a master fund partnership. Further assume that the feeder fund experiences net redemptions of \$5 million and receives that amount in cash from the master fund. Under present law, the cash distribution attributable to the partial redemption reduces the feeder fund's cost basis in its partnership interest to \$75 million. Under the Administration's proposal, the feeder fund would be treated as having disposed of a \$5 million interest in the partnership with a gain of \$1 million (\$5 million proceeds less \$4 million basis in the partnership interest). the RIC's taxable income and potential over-inclusions of taxable income -- are inappropriate for a RIC's individual investors. (3) Increased Penalties for Failure to File Correct Information Returns. The Administration has proposed again to increase the maximum penalty for failure to file correct information returns -- currently set at \$50 per return -- to the greater of \$50 per return or 5 percent of the aggregate amount required to be reported correctly (subject, in general, to a \$250,000 cap). The Institute urges that this proposal be rejected. The industry maintains a high level of information reporting compliance; the current penalty structure provides powerful incentives for RICs to correct promptly any errors made. (4) Partial Liquidations of Partnership Interests. The Administration has proposed to tax a partial liquidation of a partner's interest in a partnership as a complete liquidation of that portion of the partner's partnership interest. This proposal could have a negative impact on funds organized in the master/feeder fund structure.³ The Institute urges that this proposal be rejected because the rationale for the proposal -- to prevent deferral -- simply does not apply to partial liquidations by RIC feeder funds that need cash to meet shareholder redemptions. No deferral possibility exists because the shareholders whose redemptions triggered the need for cash are taxed currently on their redemption gains. The only effect of the proposal would be to require a taxable distribution by a RIC feeder fund of gains to its non-redeeming shareholders, who did not trigger the partial liquidation. (5) Conversions of Large C Corporations to S Corporations. The Administration has proposed to require current gain recognition on the conversion of a large C corporation to an S corporation. The Institute recommends that, should this proposal be enacted, the legislative history to the proposal include a statement making it clear that the proposal would not impact an IRS Notice (No. 88-96) that provides RICs with a safe harbor from recognition of built-in gains when a RIC temporarily fails to qualify under Subchapter M. Keith D. Lawson Senior Counsel Attachments