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HOUSE WAYS AND MEANS COMMITTEE APPROVES TAX LEGISLATION

1 See Institute Memorandum to Pension Members No. 23-97, Tax Members No. 20-97, Operations Committee No. 17-97, Transfer Agent Advisory Committee No. 26-97 and Pension Operations Advisory Committee No. 17-97, dated June 13, 1997. 2 See Institute Memorandum to Accounting/Treasurers Members No. 54-95, Closed-End Fund Committee No. 57-95, International Committee No. 38-95, Operations Committee No. 34-95, Tax Members No. 52-95, Transfer Agent Advisory Committee No. 60-95 and Unit Investment Trust Committee No. 82-95, dated November 21, 1995 (hereinafter "the November 21, 1995 memo"). June 13, 1997 TO: TAX MEMBERS No. 19-97 ACCOUNTING/TREASURERS MEMBERS No. 20-97 INTERNATIONAL COMMITTEE No. 20-97 OPERATIONS COMMITTEE No. 16-97 TRANSFER AGENT ADVISORY COMMITTEE No. 25-97 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 23-97 UNIT INVESTMENT TRUST COMMITTEE No. 41-97 RE: HOUSE WAYS AND MEANS COMMITTEE APPROVES TAX LEGISLATION ____ The House Ways and Means Committee today approved for consideration by the full House the "Revenue Reconciliation Act of 1997" (the "tax" portion of the budget bill). This memorandum summarizes many of the tax provisions in the Committee's bill that are of most interest to regulated investment companies ("RICs") and their shareholders. A separate Institute memorandum summarizes many of the most relevant pension-related provisions in the bill.1 I. Repeal of the 30 Percent Test (Attachment 1) The bill would repeal the 30 percent test of Internal Revenue Code ("Code") section 851(b)(3) for taxable years ending after date of enactment. This provision is identical to one contained in the budget bill vetoed by President Clinton in 1995.2 II. Capital Gains Provisions (Attachments 2A through 2C) A. Maximum Rate of Tax on Net Capital Gains of Individuals The bill would reduce the maximum rate of tax on net capital gains realized by individuals from 28 percent to 20 percent. Gains taxed under current law at a 15-percent rate would be taxed under the bill at a 10-percent rate. The 20-percent and 10-percent rates also would apply under the bill for alternative minimum tax purposes. These reduced maximum capital gains tax rates would apply to taxable years ending after May 6, 1997. For any taxable year that includes May 6, 1997, only the net capital gains attributable to gains or losses properly taken into account for the part of the year on or after May 7 would be entitled to the benefits of these new maximum rates. In applying the effective date rules to distributions from RICs and certain other pass-thru entities, the determination of when gains and losses are properly taken into account would be made at the entity level. B. Alternative Tax on Net Capital Gains of Corporations 3 Ways and Means Committee Chairman Archer's original proposal, as reflected in Attachment 2B, would have provided the alternative tax rates for assets held for more than 5 years. As part of the Committee's adoption of an amendment to the bill, this holding period was extended to "the number of years necessary to assure

[sufficient revenues to offset the revenue impact of the amendment]." While the new holding period has not yet been reflected in amended legislative language, an announcement was made during the Committee’s session that the holding period would be 8 years. 4 See the November 21, 1995 memo, cited in footnote 2, above. 5 A RIC would be treated as owning its proportionate share of the assets of any partnership in which it invests. A separate "at risk" rule would provide that an asset (such as a RIC’s portfolio asset) would not be treated as an indexed asset for any period during which a taxpayer’s risk of loss on the asset had been substantially reduced. 6 Mark-to-market losses, however, could never be used to reduce a taxpayer’s tax liability. 7 See the November 21, 1995 memo, cited in footnote 2, above. - 2 - Net capital gains on assets held by corporations for more than 8 years would be taxed under the bill at the following rates: 32 percent (for assets sold in 1998), 31 percent (for assets sold in 1999) and 30 percent (for assets sold after 1999).3 Special transition rules would apply to fiscal-year taxpayers for taxable years beginning in 1997, 1998 and 1999 to determine the appropriate 8-year gain for each period. For example, for taxable years ending in 1998, 8-year gain would not exceed the 8-year gain determined by taking into account only gains and losses properly taken into account for the portion of the taxable year after December 31, 1997. In applying the effective date rules to distributions from RICs and certain other pass-thru entities to corporate shareholders, the determination of when gains and losses are properly taken into account would be made at the entity level. C. Indexing Cost Basis For Inflation The bill includes the same provisions for indexing cost basis for inflation as were included in the budget bill vetoed in 1995.4 Specifically, the bill would permit individuals, for purposes of calculating gain (but not loss), to increase or "index" for inflation the cost basis of certain assets acquired after December 31, 2000 and held for more than three years. For example, if an eligible asset were purchased on January 1, 2001 for $100 and held for 10 years, during which time inflation totaled 40 percent, the indexed basis of the asset would be $140. If the asset were sold at the end of 10 years for $200, the indexed gain would be $60 ($200 - $140), rather than $100 ($200-$100), as under present law. Similarly, under the "indexing cannot create a loss" rule, if the asset were sold for between $100 and $140, the taxpayer would report neither gain nor loss. Under the bill, RICs would be permitted to index the cost basis of their indexing-eligible assets (e.g., common stock, generally, but not debt). Eligible RIC shareholders would index the cost basis of their RIC shares to the extent that the underlying RIC portfolio consisted of indexing-eligible assets.5 Specifically, RIC shares would be treated as an "indexed asset" eligible for indexing for any calendar quarter in the same ratio as the average value of the RIC’s indexed assets at the close of each month in the quarter bears to the average value of all of the RIC’s assets at the close of such months (the "indexed asset calculation"). Adopting an Institute suggestion, a "safe harbor" would treat RIC shares as eligible for (i) 100 percent of any indexing adjustment for a particular quarter if at least 80 percent of the RIC’s assets (on average) were invested in indexed assets on the last day of each month in the quarter and (ii) no inflation adjustment for that quarter if 20 percent or less of the RIC’s assets (on average) were invested in indexed assets on the last day of each month in the quarter. A special mark-to-market transition rule would permit individuals who acquired assets such as RIC shares before 2001 to index them for inflation occurring after 2000 if they (i) marked them to market using January 1, 2001 values, (ii) included in income during 2001 any resulting mark-to-market gain6 and (iii) held the assets for at least three more years. This election would be made on an asset-by-asset basis. One significant effect of the bill’s limitation of indexing benefits to individual shareholders would be to cause RICs with both corporate and individual shareholders to report different amounts of taxable income to each group, even though they would receive the same distributions. Under the bill, RICs would be required to distribute to shareholders only the amount of gain that would be taxable to individual shareholders after application of the indexing adjustment. For example, if a RIC realized a $100 gain, $40 of which was attributable to inflation, the RIC would be required to distribute only $60 to shareholders. However, because corporate shareholders would not be entitled to the benefits of indexing, RICs would have to report as dividends to these shareholders their allocable share of both the amount distributed ($60) and the amount retained ($40), all of which would be taxable to these corporate shareholders. III. Passive Foreign Investment Companies ("PFICs") (Attachment 3) The bill includes essentially the same provisions for marking to market the shares of passive foreign investment companies ("PFICs") as were included in the budget bill vetoed in 1995.7 In one important change from the 1995 bill, RICs could mark their PFIC stock to market not only at fiscal year-end, for income tax purposes, but also at October 31, for purposes of the excise tax minimum distribution requirements of Code section 4982. Under the bill, every taxpayer that holds "marketable" PFIC stock would have an election to mark that stock to market at the close of the taxpayer's taxable year. The provision would be effective for taxable years of US persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of US persons. All PFIC stock held by open-end RICs (and by closed-end RICs, except as provided by regulation) would be treated as marketable stock. Once a taxpayer made a mark-to-market election with respect to a stock, the election would apply to that stock for all subsequent years, unless the IRS consented to a revocation of the election. 8 See Institute Memorandum to Tax Members No. 13-97, dated April 16, 1997 (hereinafter "the April 16, 1997 memo"). 9 See the April 16, 1997 memo, cited in footnote 8, above. 10 See Institute Memorandum to Closed-End Investment Company Committee No. 3-97, Operations Members No. 6-97, Pension Members No. 7-97, Pension Operations Advisory Committee No. 4- 97, Tax Members No. 7-97, Transfer Agent Advisory Committee No. 8-97, Unit Investment Trust Committee No. 9-97 and Accounting/Treasurers Members No. 7-97, dated February 12, 1997 (hereinafter "the February 12, 1997 memo"). 11 The bill also would allow securities traders, commodities traders and commodities dealers to elect application of the mark-to-market rules of Code section 475 that apply presently only to securities dealers. - 3 - Any PFIC mark-to-market gain would be treated as ordinary income. PFIC mark-to-market losses would be allowable as an ordinary loss to the extent of net mark-to-market gains previously included with respect to such stock. The bill also would provide that the nondeductible "interest charge" that would otherwise be imposed on a RIC that held PFIC stock prior to the effective date of the bill would not be imposed if the RIC had elected mark-to-market treatment (presumably under proposed regulations previously issued by IRS) for the prior taxable year. IV. Foreign Tax Credit Provisions (Attachments 4A and 4B) A. Simplified Procedures for Claiming Foreign Tax Credits The bill includes the Treasury Department's recently-proposed expansion of earlier legislative proposals8 to simplify the procedures used by investors to claim credits for foreign taxes paid, including taxes deemed paid by RIC shareholders pursuant to Code section 853. Specifically, investors who pay (or are deemed to have paid) foreign taxes totaling less than $300 ($600 on a joint return) during a year, all of which are reported on IRS Forms 1099, would be permitted to claim credits against US tax for these amounts by reporting them directly on their IRS Form 1040 income tax returns, rather than first being required to complete a separate, detailed form (IRS Form 1116) used to establish eligibility for the credits. This provision would apply to taxable years beginning after December 31, 1997. B. Holding Period for Claiming Foreign Tax Credits The bill also includes the recent Treasury Department proposal9 that generally would deny a credit for foreign tax paid by an investor with respect to any dividend -- paid or accrued more than 30 days after date of enactment -- unless the taxpayer held the stock (without protection from risk of loss) on the date the dividend was paid and for at least 14 additional days immediately before and/or thereafter. Any taxpayer who failed to satisfy this 15-day holding period requirement would be allowed a deduction equal to the amount of any foreign tax credits disallowed by operation of the holding period requirement. In the case of shareholders in RICs that have made the Code section 853 election to "flow through" to shareholders their payments of foreign taxes -- which then are deemed paid by the RIC shareholders -- this holding period requirement would apply in determining whether (1) the RIC held each of its foreign securities long enough to flow through "creditable" foreign taxes and (2) the RIC shareholder held his or her RIC shares long enough to claim the foreign taxes deemed paid under Code section 853. To meet this first holding period requirement, the bill would require that a RIC include, within its notice to shareholders regarding the amount of foreign taxes deemed paid by a RIC shareholder, notification of any amount of such taxes which would not be creditable because the RIC did not meet the new holding period requirement. V. Appreciated Positions in Personal Property (Attachments 5A and 5B) A. Constructive Sale Treatment for Appreciated Financial Positions The Committee bill includes, in modified form, the Treasury Department’s proposal10 that would require a taxpayer holding an "appreciated financial position," defined generally to include an appreciated position in any stock, debt instrument (other than "straight debt") or partnership interest, to recognize gain upon entering into a "constructive sale." Among other things, the term constructive sale would include (1) entering into a short sale of the same or substantially identical property, (2) entering into an offsetting notional principal contract with respect to the same or substantially identical property, (3) entering into a futures or forward contract to deliver the same or substantially identical property and (4) acquiring the same or substantially identical property where the appreciated financial position is a short sale, an offsetting notional principal contract or an offsetting futures or forward contract. A constructive sale, however, would not include any appreciated financial position that is marked to market, including transactions subject to the securities dealer mark-to-market rules of Code section 47511 and transactions subject to mark-to-market rules of Code section 1256. A "closed transaction" exception from constructive sale treatment would be provided for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into. This exception would not apply, however, where a transaction is closed during the last 60 days of the taxable year or within 30 days thereafter unless (1) the taxpayer holds the appreciated financial position to which the transaction relates throughout the 60-day period beginning on the date the transaction is closed and (2) at no time during such 60-day period is the taxpayer’s risk of loss reduced by holding positions with respect to substantially similar or related property. A taxpayer holding property subject to the constructive sale rule would be treated as having sold and immediately repurchased the appreciated property and would receive a new basis and holding period in the property. If a taxpayer entered into a constructive sale with respect to less than all of his or her appreciated positions in the property, the property deemed sold would be determined under the general rules governing actual sales. The bill’s constructive sale provision would be effective for constructive sales entered into after June 8, 1997. In the case of transactions entered into before this date, which otherwise would have been constructive sales under the proposal, the positions would not be taken into account in determining whether 12 Under the Treasury Department’s proposal, if a constructive sale had been entered into after January 12, 1996 and before date of enactment, and not closed before 30 days after date of enactment, a constructive sale would have been deemed to occur on the date that was 30 days after date of enactment. 13 Under present law, an investment company precluded from the nonrecognition of gain or loss rules of Code sections 351 and 721 is defined, by Treas. Reg. section 1.351-1(c)(1), to include RICs, real estate investment trusts ("REITs") and any other corporation "more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations) are held for investment and are readily marketable stocks or securities, or interests in [RICs] or [REITs]." 14 This definition of investment company is somewhat different than the definition in the bill introduced recently by Representative Kennelly, which effectively would have defined investment company to include any corporation more than 80 percent of the value of the assets of which (excluding cash and nonconvertible debt obligations) are stocks or securities (whether or not marketable) that are held for investment. See Institute Memorandum to Tax Members No. 10-97 and Accounting/Treasurers Members No. 10-97, dated February 28, 1997. 15 See the April 16, 1997 memo, cited in footnote 8, above. 16 See the February 12, 1997 memo, cited in footnote 10, above. 17 For example, if one percent of a corporate taxpayer's assets were tax-exempt bonds (and the bonds had an adjusted basis of, say, $20 million), one percent of the taxpayer's interest expense would be disallowed. 18 See the February 12, 1997 memo, cited in footnote 10, above. 19 A comparable proposal was advanced earlier this year by the Treasury Department. See the February 12, 1997 memo, cited in footnote 10, above. - 4 - a constructive sale after June 8, 1997 has occurred, provided that the taxpayer identifies the offsetting positions of the earlier transaction within 30 days after date of enactment.12 B. Restrictions on Swap Funds The ability of investors to contribute appreciated assets on a tax-free basis to diversified investment pools known as "swap funds" would be restricted by the bill, effective for transfers after June 8, 1997 (unless the transfer is pursuant to a written binding contract in effect on that date). Under the bill, the definition of investment company -- contributions to which generate capital gain or loss13 -- would be expanded to include any company if more than 80 percent of the value of its assets are attributable to money, any financial instrument, any foreign currency, any interest in certain investment pools (including RICs and publicly traded partnerships), certain other assets (whether or not actively traded or marketable) and any other asset specified in Treasury regulations.14 VI. Offshore Funds "Principal Office/Ten Commandments" Safe Harbor (Attachment 6) Adopting a recent Treasury Department proposal,15 the bill would eliminate the requirement, imposed by Code section 864(b) and the so-called "ten commandment" regulations of Treas. Reg. section 1.864-2(c)(2)(iii), that certain foreign persons (including certain offshore investment funds) buying and selling US securities establish their "principal office" outside the US to avoid being treated as engaged in a US trade or business. As noted by the Treasury Department, the primary current impact of the principal office requirement is to shift certain administrative jobs to foreign tax haven jurisdictions, and to limit the business opportunities of US investment managers by increasing the costs of organizing and operating US-based investment funds. This proposal would apply to taxable years beginning after December 31, 1997. VII. Extension of Pro Rata Disallowance of Tax-Exempt Interest Expense (Attachment 7) The Committee bill adopts with modifications the Treasury Department's proposal16 pursuant to which all corporations (other than insurance companies) investing in tax-exempt obligations generally would be disallowed deductions for a portion of their interest expense equal to the portion of their total assets that is comprised of tax-exempt investments.17 Pursuant to a de minimis exception provided by the bill, however, this disallowance rule would not apply to any corporation, other than a financial institution or dealer in tax-exempt obligations, if the average adjusted basis of tax-exempt obligations acquired by the corporation after August 7, 1986 is less than the lesser of $1 million or 2 percent of the basis of all of the corporation's assets. The bill's disallowance rule would apply to taxable years beginning after the date of enactment with respect to obligations acquired after June 8, 1997. VIII. Dividends Received Deduction Holding Period Requirement (Attachment 8) The bill also adopts the Treasury Department's proposal18 that would make the dividends received deduction generally unavailable if the 46-day holding period for the stock (or the 91-day holding period for certain preferred stock) is not satisfied by the taxpayer (without protection from risk of loss) over a period immediately before or immediately after the taxpayer becomes entitled to the dividend. This change would be effective for dividends paid or accrued after the 30th day after date of enactment. IX. OID Where Pooled Debt Obligations Subject to Acceleration (Attachment 9) The bill would extend the special rules for determining original issue discount ("OID"), applicable to any regular interest in a real estate mortgage investment conduit ("REMIC"), qualified mortgages held by a REMIC or certain other debt instruments, to any pool of debt instruments the payments on which may be accelerated by reason of prepayments.19 For example, a taxpayer holding a pool of credit card receivables that require interest to be paid if the borrowers do not pay their accounts by a specified date would be required by the bill to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool. The proposal would be effective, in general, for taxable years beginning after date of enactment. X. Publicly Traded Partnerships (Attachment 10) - 5 - The treatment of so-called "grandfathered" publicly traded partnerships, which are to become taxable as corporations (rather than treated as partnerships) for taxable years beginning after December 31, 1997, would be modified by the bill. Specifically, any existing publicly traded partnership (other than one that receives this status under the passive-type income exception of Code section 7704(c)(1)) could elect to maintain its treatment as a partnership (rather than become taxable as a corporation) so long as it paid a tax equal to 15 percent of its gross income from the active conduct of a trade or business (with no offset for tax credits). This proposal would be effective for taxable years beginning after December 31, 1997. XI. Gains and Losses from Certain Terminations (Attachment 11) The bill would modify in two ways the taxation of gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to certain personal property. First, the rule in Code section 1234A -- that treats as capital (rather than ordinary) the gain or loss from the extinguishment of certain rights or obligations -- would be extended by the bill to all types of property, effective for property acquired or positions established more than 30 days after date of enactment. Second, the bill would treat as capital (rather than ordinary) the gain or loss from the retirement of debt obligations issued by natural persons, generally effective for debt purchased or issued more than 30 days after date of enactment. XII. Delay in Imposition of Penalties for Failure to Make Payments Electronically (Attachment 12) Pursuant to a Congressional mandate, the Treasury Department has developed and begun implementation of an electronic funds transfer system (known as the Electronic Federal Tax Payment System or "EFTPS") for use by all employers and payors (hereinafter "taxpayers") remitting withheld taxes (including backup withholding). The phased-in implementation schedule developed by Treasury to meet the Congressional mandate presently calls for all taxpayers who deposited more than $50,000 in tax in 1995 to begin using EFTPS by July 1, 1997. Because of concerns that some taxpayers might not be sufficiently aware of their obligations to use EFTPS, Treasury has announced that penalties for failure to use EFTPS will not be imposed on taxpayers that make timely deposits during 1997 using paper federal tax deposit coupons while converting to EFTPS. Under the bill, no penalty would be imposed solely by reason of a failure to use EFTPS during the period from July 1, 1997 through December 31, 1998, if the taxpayer was first required to use the EFTPS system on or after July 1, 1997. * * * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachments (in .pdf format) Note: Not all recipients of this memo will receive the attachments. If you wish to obtain a copy of any of the attachments referred in this memo, please call the Institute’s Information Resource Center at (202) 326-8304 and indicate that you would like copies of attachments for memo number: 8984.