INVESTMENT COMPANY INSTITUTE

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TAXPAYER REFUND AND RELIEF ACT OF 1999 APPROVED BY CONGRESS

1 The relevant pension-related provisions will be summarized in a separate Institute Memorandum. [11173] August 9, 1999 TO: ACCOUNTING/TREASURERS MEMBERS No. 22-99 CLOSED-END INVESTMENT COMPANY MEMBERS No. 30-99 INTERNATIONAL MEMBERS No. 22-99 OPERATIONS MEMBERS No. 20-99 TAX MEMBERS No. 26-99 TRANSFER AGENT ADVISORY COMMITTEE No. 51-99 UNIT INVESTMENT TRUST MEMBERS No. 18-99 RE: TAXPAYER REFUND AND RELIEF ACT OF 1999 APPROVED BY CONGRESS ____ Congress has approved H.R. 2488, the "Taxpayer Refund and Relief Act of 1999" (hereinafter, the "Act") by votes of 221 to 206 in the House and 50 to 49 in the Senate, with one Senator absent. As urged by the Institute, the Act would permit US funds (treated for federal tax purposes as regulated investment companies or "RICs") to "flow through" the character of interest and short-term capital gains to their foreign shareholders. President Clinton has indicated that he would veto the Act if it were presented to him in its current form because of the magnitude of the Act's tax cut provisions. This memorandum discusses the following attached provisions of interest to regulated investment companies ("RICs") and their shareholders:1 (1) flow-through treatment for interest and short-term capital gains paid by RICs to their foreign shareholders; (2) proposed revisions affecting the taxation of capital gains, including a provision to 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, 1999 and held for more than one year; (3) the treatment of income derived by RICs from interests in publicly traded partnerships; (4) the treatment of distributions of accumulated earnings and profits from a "non-RIC" year; and (5) the treatment of gain from constructive ownership transactions, including certain "synthetic" investments in RICs. Note, however, that the Act contains the attached "sunset" provision (Attachment F) designed to comply with procedures under the Congressional Budget Act of 1974 by which Congress implements spending and tax policies contained in a budget resolution. Specifically, the Act provides that all of its provisions and amendments that are in effect on September 30, 2009 will cease to apply as of that date. The Act further provides that certain of its provisions, including those described in this memorandum affecting the taxation of capital gains, will cease to apply for taxable years beginning after December 31, 2008. Flow Through of Interest and Short-Term Capital Gains to Foreign Investors (Attachment A) 2 See Institute Memorandum to Tax Members No. 24-97, Accounting/Treasurers Members No. 23-97, International Committee No. 24-97, Operations Committee No. 20-97, Transfer Agent Advisory Committee No. 30-97, Closed-End Investment Company Committee No. 25-97 and Unit Investment Trust Committee No. 45-97, dated June 27, 1997. 3 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. The Act generally would permit the character of interest and short-term capital gains to flow through a RIC to its foreign shareholders without imposition of US withholding tax. For these purposes, US-source and foreign-source interest that is free from foreign withholding tax under the domestic laws of the source country (such as interest from “Eurobonds”) would be eligible for flow- through treatment. The Act would, however, deny flow-through treatment for interest from any foreign bond on which the source-country tax rate is reduced pursuant to a tax treaty with the United States. The provision would apply to taxable years beginning after December 31, 2004. The Institute fully supports this “flow-through” legislation because it would eliminate the US withholding tax barrier to foreign investment in US funds, while containing appropriate safeguards to ensure that (1) flow-through treatment applies only to interest income that would be exempt from US withholding tax if received by a foreign investor directly or through a foreign fund and (2) foreign investors cannot avoid otherwise-applicable foreign tax by investing in US funds that qualify for treaty benefits under the US income tax treaty network. Capital Gains Provisions (Attachment B) A. Indexing Cost Basis for Inflation The Act includes provisions for indexing cost basis for inflation that are very similar to those included in tax legislation approved by the House in 1997.2 Specifically, the Act 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, 1999 and held for more than one year. For example, if an eligible asset were purchased on January 1, 2000 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. The Act would permit RICs 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.3 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 of the quarter bears to the average value of all of the RIC’s assets at the close of such months (the “indexed asset calculation”). As suggested by the Institute, a “safe harbor” would treat RIC shares as eligible for (1) 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 as of the last day of each month in the quarter and (2) 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. 4 Mark-to-market losses, however, never could be used to reduce a taxpayer’s tax liability. 5 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. A special mark-to-market transition rule would permit individuals who acquired assets such as RIC shares before 2000 to index them for inflation occurring after 1999 if they (1) marked them to market using January 1, 2000 values, (2) included in income during 2000 any resulting mark-to-market gain4 and (3) held the assets for at least one more year. This election would be made on an asset-by-asset basis. One significant effect of the Act’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 Act, 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. B. Reduction in Maximum Rate of Tax on Net Capital Gains of Individuals The Act would reduce the maximum rate of tax on net capital gains realized by individuals from 20 percent to 18 percent. Gains taxed under current law at a 10-percent rate would be taxed under the Act at an 8 percent rate. The 18-percent and 8-percent rates would apply under the Act for alternative minimum tax purposes. The 18-percent and 8-percent rates provided for “qualified 5-year gains” by the Taxpayer Relief Act of 19975 would be repealed as obsolete. The reduced maximum capital gains rates would apply to taxable years beginning after December 31, 1998. Income Derived from Interests in Publicly Traded Partnerships (Attachment C) The Act would amend section 851(b) to treat the gross amount of income derived by a RIC from an interest in a publicly traded partnership as qualifying income under Subchapter M. For this purpose, the Act provides that qualifying income of a publicly traded partnership would be determined at the entity level, rather than on a “look-through” basis. The Act also would extend the special “passive loss” rules for publicly traded partnerships to RICs holding interests in such partnerships. Under section 469(k) (as modified by the Act), a RIC would be required separately to apply the passive loss rules with respect to items attributable to each publicly traded partnership interest. The provision would apply to taxable years beginning after December 31, 2000. Distribution of Accumulated Earnings and Profits from a Non-RIC Year (Attachment D) The Act would make three modifications to the provisions of Subchapter M that impact certain RICs with accumulated earnings and profits from “non-RIC” years. A RIC may acquire such earnings and profits through either a conversion from non-RIC to RIC status or a merger with a non-RIC. First, the Act would amend section 852(c) to provide that any distribution made to satisfy the requirement that a RIC have no non-RIC earnings and profits as of the end of the taxable year “shall be treated . . . as made from the earliest earnings and profits accumulated in any taxable year to which the provisions of this part did not apply.” This would represent a change from current law under which distributions from earnings and profits essentially are treated as being made on a last in, first out basis. Second, the Act would provide that a distribution treated as being made from accumulated earnings and profits shall not be treated as a distribution for purposes of calculating the dividends paid deduction under section 852(b)(2)(D) or the “spillover” dividend rules of section 855. This change expressly would permit a RIC to use a spillover dividend to distribute its taxable income for a year in which it acquires non-RIC earnings and profits that it must distribute. Third, the Act would expand the “deficiency dividend” relief provided by section 852(e) where a failure to qualify under Subchapter M is attributable solely to a failure to distribute non-RIC earnings and profits. Under the provision, a deficiency-type distribution of non-RIC earnings and profits would permit the RIC to qualify in the initial year to which a failed determination under Subchapter M applied, in addition to subsequent years (before the deficiency-type distribution is made). These provisions would apply to distributions after December 31, 2000. Treatment of Gain from Constructive Ownership Transactions (Attachment E) The Act would prevent the conversion of ordinary income or short-term capital gain into income eligible for long-term capital gain treatment with respect to certain “constructive ownership transactions” involving, among other things, an equity interest in a pass-thru entity (that would be defined to include a RIC). Under proposed new section 1260, a taxpayer generally would be treated as having entered into a constructive ownership transaction with respect to a pass-thru entity if the taxpayer: (1) holds a long position under a swap contract with respect to the entity; (2) enters into a forward or futures contract to acquire the entity; (3) is the holder of a call option, and is the grantor of a put option, with respect to the entity and the such options have substantially equal strike prices and substantially contemporaneous maturity dates; or (4) enters into one or more other transactions (or acquires one or more positions) that have substantially the same effect as a transaction described above. More specifically, the Act would (1) limit the amount of long-term gain to the long-term gain, if any, that the taxpayer would have received had an investment been made directly in the underlying pass- thru entity (an amount termed the "net underlying long-term capital gain") and (2) impose an interest charge on any deferred short-term gain. An exception to this treatment would be provided if all of the positions that are part of the transaction are marked to market. Under the Act's effective date, the constructive ownership provisions would apply to transactions entered into after July 11, 1999. For this purpose, a contract, option or any other arrangement that is entered into or exercised on or after July 12, 1999 which extends or otherwise modifies the terms of a transaction entered into prior to such date is treated as a transaction entered into on or after July 12, 1999. Deanna J. Flores Assistant Counsel Attachment Note: Not all recipients receive the attachment. 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