MEMO# 9003

June 20, 1997

SENATE FINANCE COMMITTEE APPROVES TAX LEGISLATION

1 The attachments to this memorandum are explanations prepared by Congress' Joint Committee on Taxation. The actual statutory language for the bill was not available when this memorandum was distributed. 2 The relevant pension-related provisions in the bill are summarized in Institute Memorandum to Pension Members No. 24-97, Tax Members No. 22-97, Operations Committee No. 18-97, Pension Operations Advisory Committee No. 18-97 and Transfer Agent Advisory Committee No. 28-97, dated June 20, 1997. 3 See Institute Memorandum 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 and Unit Investment Trust Committee No. 41-97, dated June 13, 1997. June 20, 1997 TO: TAX MEMBERS No. 23-97 ACCOUNTING/TREASURERS MEMBERS No. 22-97 INTERNATIONAL COMMITTEE No. 23-97 OPERATIONS COMMITTEE No. 19-97 TRANSFER AGENT ADVISORY COMMITTEE No. 29-97 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 24-97 UNIT INVESTMENT TRUST COMMITTEE No. 42-97 RE: SENATE FINANCE COMMITTEE APPROVES TAX LEGISLATION ____ The Senate Finance Committee has approved for consideration by the Senate the "Revenue Reconciliation Act of 1997." This memorandum summarizes the tax provisions in the Committee's bill (attached)1 that are of most interest to regulated investment companies ("RICs") and their shareholders.2 In addition, the memorandum compares the Senate Finance Committee bill with the bill approved recently by the House Ways and Means Committee.3 I. Repeal of the 30 Percent Test (Attachment 1) The Senate bill adopts, with a change in the effective date, the House bill proposal to repeal the 30 percent test of Internal Revenue Code ("Code") section 851(b)(3). Under the Senate bill, the repeal provision would apply prospectively, to taxable years beginning after December 31, 1997, rather than, as under the House bill, to taxable years ending after date of enactment. 4 This provision was added to the Code in 1993. See Institute Memorandum to Accounting/Treasurers Members No. 24-93, Pension Members No. 28-93 and Tax Members No. 28-93, dated August 9, 1993. 5 No comparable provision was included in the House bill. - 2 - II. Capital Gains Provisions (Attachment 2) A. Maximum Rate of Tax on Net Capital Gains of Individuals The Senate bill adopts provisions, identical to those in the House bill, regarding the maximum rate of tax on net capital gains of individuals. Specifically, the Senate 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. Qualified Small Business Stock Under the Senate bill, the 50 percent exclusion provided by Code section 12024 for gains realized by individuals upon the disposition of "qualified small business stock" held for more than 5 years would be modified in several respects.5 First, corporations as well as individuals would be eligible to claim the 50 percent exclusion. Second, the maximum size of a corporation eligible for qualified small business stock status would be doubled, from gross assets of $50 million to gross assets of $100 million. These two changes would be effective for stock issued after date of enactment. In two other proposed changes, both of which would be effective for stock issued after August 10, 1993 (the original effective date of the provision), (1) the present law limit on the amount of qualified small business stock gain realized by an individual that is eligible for the exclusion (the greater of ten times the taxpayer's basis in the stock or $10 million) would be repealed and (2) a taxpayer would have 60 days following the sale or exchange of qualified small business stock to roll over the gain in a tax-free transaction to another investment in qualified small business stock. III. Passive Foreign Investment Companies ("PFICs") (Attachment 3) The Senate bill adopts provisions, identical to those in the House bill, regarding marking to market the shares of passive foreign investment companies ("PFICs"). 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 fiscal year, for income tax purposes, but also at October 31, for purposes of the excise tax minimum distribution requirements of Code section 4982. 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. 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 otherwise would 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 Senate bill adopts provisions, identical to those in the House bill, regarding the simplified procedures by which investors could 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 Senate bill, like the House bill, 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 dividend entitlement date 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 6 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. 7 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. 8 Under present law, an investment company precluded from the nonrecognition of gain 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]." 9 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. - 3 - 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 (Attachment 5) A. Constructive Sale Treatment for Appreciated Financial Positions The Senate bill adopts provisions, identical to those in the House bill, 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 4756 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 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.7 B. Restrictions on Swap Funds As under the House bill, the Senate bill would restrict the ability of investors to contribute appreciated assets on a tax-free basis to diversified investment pools known as "swap funds," 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 may generate capital gain8 -- 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.9 VI. Offshore Funds "Principal Office/Ten Commandments" Safe Harbor (Attachment 6) The Senate bill, like the House 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) trading US securities for their own account establish their "principal office" outside the US to avoid being treated as engaged in a US trade or business. This change would apply to taxable years beginning after December 31, 1997. 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. VII. Dividends Received Deduction Holding Period Requirement (Attachment 7) The Senate bill, like the House bill, 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. Under both bills, this change generally would be effective for dividends paid or accrued after the 30th day after date of enactment. Under the Senate bill, however, a two-year transition rule would be provided from the requirement that the holding period be satisfied for each dividend, for hedged positions entered into before June 9, 1997, so long as the taxpayer identifies and maintains the hedged position. VIII. Publicly Traded Partnerships (Attachment 8) 10 Pursuant to a de minimis exception in the House 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. 11 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). 12 See Institute Memorandum to Tax

Committee No. 12-97, dated April 1, 1997 (hereinafter the April 1, 1997 memo). 13 See the February 12, 1997 memo, cited in footnote 11, above. 14 See the April 1, 1997 memo, cited in footnote 12, above. - 4 - The Senate bill adopts, with a change in the applicable tax rate, the proposed modifications included in the House bill to 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. Under the bill, 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 3.5 percent (rather than 15 percent, as under the House bill) 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. IX. Gains and Losses from Certain Terminations (Attachment 9) The Senate bill, like the House 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 issued or purchased after June 8, 1997 (rather than, as in the House bill, more than 30 days after date of enactment). X. Delay in Imposition of Penalties for Failure to Make Payments Electronically (Attachment 10) Under the Senate bill, as under the House bill, employers and payors who, on or after July 1, 1997, become subject to the requirement to remit withholding taxes (including backup withholding) electronically using the Electronic Federal Tax Payment System (or "EFTPS") would not be penalized merely for a failure, during the period from July 1, 1997 through December 31, 1998, to make them using EFTPS. XI. Provisions in House Bill That Are NOT in Senate Bill A. Indexing Cost Basis for Inflation The Senate bill does not include the House proposal to index for inflation the cost basis of capital assets acquired after December 31, 2000 and held for more than three years. B. Alternative Tax on Net Capital Gains of Corporations The Senate bill does not include the House proposal to reduce the maximum tax rate on net capital gains on assets held by corporations for more than 8 years to 32 percent (for assets sold in 1998), 31 percent (for assets sold in 1999) and 30 percent (for assets sold after 1999). C. Disallowance of Interest on Indebtedness Allocable to Tax-Exempt Obligations The Senate bill does not include a provision such as the one included in the House bill pursuant to which 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.10 D. OID Where Pooled Debt Obligations Subject to Acceleration The Senate bill does not include the House bill provision that 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. XII. Provisions NOT in Either House or Senate Bill A. Mandatory Use of the Average Cost Basis Method by All Securities Sellers Neither the Senate nor the House bill includes the Treasury Department proposal,11 strongly opposed by the Institute,12 to require that all securities sellers compute cost basis using the average cost method. B. Increased Penalties for Failure to File Correct Information Returns Neither bill includes the Treasury Department proposal,13 opposed by the Institute,14 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). 15 See, e.g., Institute Memorandum to International Members No. 9-97 and Tax Members No. 18-97, dated June 9, 1997. - 5 - C. Flow Through of Interest and Short-Term Capital Gains to Foreign Investors Neither bill includes the proposal, included in recent "international tax simplification" and "investment competitiveness" bills,15 to permit the character of US-source interest income and short-term capital gains to flow through a RIC to foreign shareholders. The Institute supports this "flow through" legislation because it would eliminate a US tax barrier that effectively encourages foreign investors to invest in US securities either directly or through foreign, rather than US, funds. * * * 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 to 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: 9003.
