MEMO# 1608

December 19, 1989

OMNIBUS BUDGET RECONCILIATION ACT OF 1989 (OBRA) ENACTED

- 1 - December 19, 1989 TO: CLOSED-END FUND MEMBERS NO. 68-89 TAX MEMBERS NO. 48-89 UNIT INVESTMENT TRUST MEMBERS NO. 70-89 OPERATIONS COMMITTEE NO. 27-89 ACCOUNTING/TREASURERS COMMITTEE NO. 55-89 TRANSFER AGENT ADVISORY COMMITTEE NO. 31-89 RE: OMNIBUS BUDGET RECONCILIATION ACT OF 1989 (OBRA) ENACTED ____ The Omnibus Budget Reconciliation Act of 1989 ("OBRA") was passed by Congress on November 22, 1989; on December 19, 1989, President Bush signed the Act into law. Many important tax provisions affecting regulated investment companies ("RICs") are included in the Act. Most of these provisions are similar to provisions included in the House and Senate bills. (See Institute Memoranda to Tax Members No. 42-89, Closed-End Fund Members No. 61-89, Unit Investment Trust Members No. 58-89, Accounting/Treasurers Committee No. 46-89, Operations Committee No. 21-89 and Transfer Agent Shareholder Advisory Committee No. 27-89, dated October 24, 1989; and to Tax Members No. 32-89, Closed-End Fund Members No. 43-89, Unit Investment Trust Members No. 49-89, Accounting/Treasurers Committee No. 38-89, Operations Committee No. 17-89, and Transfer Agent Shareholder Accounting Advisory Committee No. 24-89, dated September 27, 1989.) The following is a summary of the provisions of the Act which affect RICs and their shareholders. The relevant portions of the Act and the Conference Committee Report are attached. I. PHANTOM INCOME 1. Phantom Income (Attachment 1) The Act modifies Code section 67(c) to permanently exclude "publicly offered regulated investment companies" (as that term is defined in section 67(c)(2)(B)) from the application of the phantom income tax. As you know, Congress inadvertently repealed the phantom income tax last year in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). (See Institute - 2 - Memorandum to Tax Members No. 59-88, Closed-End Fund Members No. 55-88, Unit Investment Trust Members No. 69-88 and Accounting/ - 3 - Treasurer Advisory Committee No. 41-88, dated November 14, 1988). In OBRA, this year, Congress reinstated the phantom income tax for certain entities other than publicly offered regulated investment companies. Specifically, Congress repealed section 67(c)(4), which would have terminated all of section 67(c) effective January 1, 1990, but did not repeal or place any termination date on the exception from section 67(c) for publicly offered regulated investment companies. The effect of the statutory change is to eliminate the need for further extensions of the exemption from the phantom income tax for shareholders in publicly offered regulated investment companies; the exemption is now permanent. II. RIC-SPECIFIC PROVISIONS 2. Section 4982 Ordinary Income Distribution Requirement (Attachment 2). The Act increases the section 4982 minimum distribution requirement for ordinary income from 97 percent to 98 percent. This amendment applies to calendar years ending after July 10, 1989. 3. Sales Load Basis Deferral (Attachment 3). Section 852 is amended by the Act to require any shareholder who purchases shares in one RIC (RIC "A"), and either (i) redeems out of RIC "A" and then reinvests in RIC "A" or (ii) transfers all or part of the investment in RIC "A" to a second RIC (RIC "B"), to exclude from the basis of any RIC "A" shares that are disposed of within 90 days from the purchase date (rather than 6 months in the Senate bill or 30 days in the House bill) the sales load incurred in acquiring those shares to the extent that the sales load on the later-acquired shares is reduced because a load was previously paid in acquiring the RIC "A" shares. Any sales charge not included in the basis of RIC "A" shares will be treated as incurred to acquire the new shares. However, the new shares acquired will also be subject to this 90 day holding period requirement. This amendment applies to sales loads incurred after October 3, 1989. 4. Dividend Accrual on Ex-dividend Date (Attachment 4). The Act amends section 852(b) to require a RIC to treat a dividend declared with respect to stock owned on the record date as received on the later of (i) the date the stock owned by the RIC becomes ex-dividend with respect to such dividend, or (ii) the date the RIC acquires such stock. If the dividend is not paid, the RIC will receive a loss when it is established that the dividend will not be received. This amendment applies to any dividend where the stock becomes ex-dividend on or after December 20, 1989 (the day after the date of enactment - December 19, - 4 - 1989). - 5 - III. RIC-RELATED PROVISIONS 5. Applicable High Yield Discount Obligations (Attachment 5). The Act bifurcates original issue discount ("OID") on "applicable high yield discount obligations" into two parts. No deduction is permissible to the issuer for the "disqualified portion" of the OID; the deduction for the remainder of such OID will not be allowable until paid. The holder of an applicable high yield discount obligation (such as a RIC) will generally treat the disqualified portion of the OID as a dividend for purposes of the dividends received deduction. An "applicable high yield discount obligation" is defined as, any debt instrument (i) with a maturity date of more than 5 years from the date of issue, (ii) with a yield to maturity that equals or exceeds the sum of the applicable Federal rate for the calendar month in which the obligation was issued plus 5 percentage points, and (iii) which has "significant original issue discount." The disqualified portion of the OID is generally the portion of the total return on the obligation that bears the same ratio to the total return as the disqualified yield bears to the total yield to maturity on the instrument. The term "disqualified yield" means that portion of the yield that exceeds the applicable Federal rate for the month in which the obligation was issued (the "AFR") plus six percentage points. This provision is effective generally for instruments issued after July 10, 1989. An assumption by a taxpayer of an instrument issued by another taxpayer is treated as a new issuance for purposes of this rule. The effective date rule is subject to exceptions, however, including one which exempts from the rule those instruments issued pursuant to the terms of a debt instrument that was issued before the effective date, such as a payment-in-kind ("PIK") bond issued after July 10, 1989 as interest on a PIK bond issued before July 10, 1989. 6. Disqualified Preferred Stock (Attachment 6). The Act amends section 1059 to treat as an extraordinary dividend any dividend with respect to "disqualified preferred stock," i.e., a stock which (i) when issued, had a dividend rate that declined (or could reasonably be expected to decline) in the future, (ii) had an issue price that exceeded its liquidation rights or its stated redemption price, or (iii) was otherwise structured to avoid the other provisions of section 1059 and to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock. The provision is not intended to apply to (i) preferred stock dividends where the declining dividend rate is due to an - 6 - unforeseen economic downturn in the issuer's business or (ii) - 7 - dividends on floating rate or auction rate preferred stock whose dividend rate declines solely in response to market changes. Treatment of a dividend as extraordinary will result in a reduction in a corporate shareholder's basis in its stock by the portion of the dividend eligible for the dividends received deduction. This amendment applies generally to stock issued after July 10, 1989.

7. Debt/Equity Regulatory Authority (Attachment 7). The Act clarifies the Treasury Department's regulatory authority under section 385 to treat an instrument as part stock and part debt. This authority applies prospectively with respect to instruments issued after public guidance is released. 8. Reduction in Built-In Gain or Loss Threshold (Attachment 8). The Act restricts the use of net unrealized built-in gains and losses under sections 382 and 384. Under pre-OBRA law, the limitations on the use of such gains or losses applied only if the net unrealized built-in gain or loss exceeded 25 percent of the fair market value of the corporation's assets. Under the Act, these limitations will apply if the net unrealized built-in gain or loss exceeds the lower of (1) 15 percent of the fair market value of the corporation's assets or (2) $10 million. This provision is generally effective for ownership changes and acquisitions after October 2, 1989. 9. Foreign Currency Gains and Losses (Attachment 9). The Act also provides that the income and loss characterization rules in section 988 apply without regard to other income tax provisions in the Code. Thus, where ordinary income and loss characterizations apply pursuant to section 988 to gains and losses from trading section 1256 contracts, the gains and losses will not be considered gains or losses from the sale or exchange of capital assets pursuant to section 1256(f)(3). This technical correction has the same effective date as the Technical and Miscellaneous Revenue Act of 1988 provision it amends, i.e., it applies to forward contracts, futures contracts, options and similar instruments entered into or acquired after October 21, 1988. IV. CIVIL TAX PENALTY REFORM The Act also makes numerous changes to the Code's civil tax penalty provisions. - 8 - 10. Information Reporting Penalty System (Attachment 10). Under pre-OBRA law, separate Code sections provided penalties for (1) failures to supply taxpayer identification numbers (TINs), (2) failures to file certain information returns, (3) failures to furnish certain payee statements, and (4) failures to include correct (non-TIN) information on returns or statements. The Act restructures the reporting penalties by providing specific Code sections to penalize (1) failures to file correct (non-TIN) information on IRS returns, (2) failures to furnish correct payee statements to shareholders and (3) failures to comply with other information reporting requirements (such as the requirement to supply correct TINs on returns and statements). Several other changes to the information reporting penalty provisions are also significant. First, the Act makes two changes to the TIN reporting provisions. Unlike pre-OBRA law, where the $50 per failure penalty for filing a return with no TIN or for including an incorrect TIN on a dividend return or statement was not limited by any ceiling, the Act caps the penalty for a payor at $100,000 per calendar year. A second change modifies the conditions that must be satisfied to assert a defense to the $50 penalty. Under pre-OBRA law, only a payor who exercised "due diligence" could assert a defense against the imposition of the penalty. Under the Act, no penalty will be imposed with respect to any such failure which is shown to be due to "reasonable cause" and not to "willful neglect." Due diligence is described in the House Ways and Means Committee Report (where this OBRA provision was included) as a "higher waiver standard" than reasonable cause. The Committee Report further states that "[t]he committee intends that for this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has an established history of complying with the information reporting requirements." The prior law penalties of $50 for failing to file information returns with the IRS and for failing to furnish payee statements to shareholders are combined under the Act with the $5 penalty for failing to include correct (non-TIN) information on returns or statements in two new penalties: (1) a $50 per failure penalty for failing to file correct information returns to the IRS and (2) a $50 per failure penalty for failing to furnish correct payee statements to shareholders. The Act caps the $50 penalty for failing to file correct information returns to the IRS at $250,000 and caps the $50 penalty for failing to furnish correct payee statements to shareholders at $100,000. As under pre-OBRA law, these failure to file and failure to furnish penalties will not be imposed with respect to any failure

shown to be due to reasonable cause and not to willful neglect. - 9 - In addition, the penalty for failure to file correct information returns with the IRS is modified to provide a sliding scale penalty schedule. Thus, payors are encouraged to file correct information returns even though such returns might be filed after the prescribed filing date. The sliding scale penalty system will not apply to either failures to include correct TINs on information returns or statements or failures to provide correct payee statements to shareholders. The Act also provides that when incorrect information returns filed with the IRS are corrected on or before August 1 of that year, the original return will be treated as having been filed with the correct information. This relief will be limited, however, to the greater of 10 returns or one-half of one percent of the total number of returns that are required to be filed by the person during the calendar year. Failures to include correct TINs on information returns and statements and failures to provide correct payee statements to shareholders will not be eligible for this relief. Pre-OBRA rules for failures that are due to intentional disregard of the filing requirements will be retained under the Act for failures to file correct information returns with the IRS and will be added for failures to furnish correct payee statements to shareholders. As under pre-OBRA law, no special rules will apply to any intentional disregard of the requirements to supply TINs on returns filed with the IRS or on statements sent to shareholders. The information reporting provisions of the Act generally apply to information returns and payee statements the due date for which (determined without regard to extensions) is after December 31, 1989. 11. Delinquency Penalties (Attachment 11). The Act modifies the penalty for the failure to make timely deposits of tax in order to encourage depositors to correct their failures. Under pre-OBRA law, a penalty could be imposed equal to 10 percent of the amount of the underpayment unless it was shown that the failure was due to reasonable cause and not willful neglect. The Act imposes a four-tier penalty structure under which a depositor's penalty will increase the longer the underpayment remains uncorrected. As under pre-OBRA law, no penalty will be imposed if the failure to make a timely deposit is due to reasonable cause and not willful neglect. This modification will apply to deposits that are required to be made after December 31, 1989. In addition, the Act provides that in cases where a tax on the U.S. income of a foreign person is required to be withheld, but has not in fact been withheld, and the person who would have - 1 0 - been entitled to a credit for any tax withheld has satisfied its proper tax liability, the withholding agent will remain liable - 1 1 - for any penalties and additions to tax otherwise applicable for failure to withhold. This modification applies to failures to deduct and withhold taxes after December 31, 1989. 12. Administrative Recommendations to the IRS (Attachment 12). The House Ways and Means Committee included in their Report numerous administrative recommendations to the IRS regarding the information reporting system which are also adopted by the Conference Committee. The first recommendation, for example, states that "[t]he IRS should adopt a clear policy of working with the third-party payor community to assure accurate and timely filing of information, in a format that is usable by the IRS and the taxpayer without unduly burdening the third party that is required to provide this information." Many of the other recommendations are also relevant. V. MISCELLANEOUS NON-TAX MATTER 13. HUD Refinancing (Attachment 13) The recently enacted appropriation bill for the Department of Housing and Urban Development ("HUD") contains a provision for HUD to initiate a program to offer incentives for homeowners to refinance Section 235 FHA-insured loans. It is expected by Congress that HUD will implement this provision in a manner that will not unnecessarily impact secondary market operations. * * * We will keep you informed of developments regarding this legislation. Keith D. Lawson Assistant General Counsel Attachments