MEMO# 1416

September 27, 1989

HOUSE WAYS AND MEANS COMMITTEE APPROVES TAX PROVISIONS IN OMNIBUS RECONCILIATION ACT OF 1989 (ORA)

- 1 - September 27, 1989 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 TRANSFER AGENT SHAREHOLDER ADVISORY COMMITTEE NO. 24-89 RE: HOUSE WAYS AND MEANS COMMITTEE APPROVES TAX PROVISIONS IN OMNIBUS RECONCILIATION ACT OF 1989 (ORA) ____ The House Ways and Means Committee recently approved the revenue reconciliation provisions of the Omnibus Reconciliation Act of 1989 (ORA). The civil tax penalty provisions included in this bill were approved by the Ways and Means Committee earlier this year. (See Institute Memorandum to Closed-End Fund Committee No. 23-89, Unit Investment Trust Committee No. 32-89, Transfer Agent Shareholder Advisory Committee No. 14-89, Operations Members No. 18-89 and Tax Members No. 21-89, dated July 6, 1989). The following is a summary of the provisions of the bill which affect regulated investment companies ("RICs") and their shareholders. The relevant portions of the bill and the Ways and Means Committee Report are attached. I. PHANTOM INCOME No provision regarding phantom income (section 67(c)) is included in the bill. As we previously informed you, when Congress enacted the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) last year, it intended to postpone imposition of the phantom income tax on publicly-offered RICs until 1990. However, the enacted TAMRA language both delayed the application of section 67(c) to publicly-offered RICs until 1990 and repealed section 67(c) entirely for taxable years beginning after 1989. (See Institute Memorandum to Tax Members No. 59-88, Closed-End Fund Members No. 55-88, Unit Investment Trust Members No. 69-88 and Accounting/Treasurer Advisory Committee No. 41-88, dated - 2 - November 14, 1988). This year, during its deliberation of the tax bill, the House Ways and Means Committee determined that the repeal of section 67(c) should be permitted to go into effect at the end of 1989 without modification. Consequently, no special provision regarding phantom income was included in the bill. II. RIC-SPECIFIC PROVISIONS 1. Section 4982 Ordinary Income Distribution Requirement (Attachment 1). The bill would increase the section 4982 minimum distribution requirement for ordinary income from 97 percent to 98 percent. This amendment would apply to calendar years ending after July 10, 1989. 2. Sales Load Basis Deferral (Attachment 2). Section 852 would be amended by the bill to require any shareholder who purchased shares in one RIC (RIC "A") and transferred all or part of that investment to a second RIC in the same investment company complex (RIC "B") to exclude from the basis of any RIC "A" shares that were disposed of within 30 days the sales load incurred on those shares to the extent that the sales load on the RIC "B" shares was reduced because a load had previously been paid on the RIC "A" shares. Any sales charges not included in the basis of RIC "A" shares would be treated as incurred to acquire the RIC "B" shares. This amendment would apply to sales loads incurred after July 10, 1989 in taxable years ending after such date. 3. Dividend Accrual on Ex-dividend Date (Attachment 3). The bill would amend section 852(b) to require a RIC to treat a dividend as received on the date the stock owned by the RIC became ex-dividend with respect to such dividend. This amendment would apply to any dividend where the stock became ex- dividend after the bill's date of enactment. III. TAXATION OF CAPITAL ASSETS The taxation of capital assets would be substantially modified under the bill. The tax rate on certain assets would be temporarily reduced until December 31, 1991. Thereafter, the basis of certain assets would be indexed for inflation. 4. 30 Percent Exclusion (Attachment 4). The bill would reduce the capital gains tax for individual and other non-corporate taxpayers for assets, other than collectibles, sold or exchanged during the period beginning september 14, 1989 and ending December 31, 1991 ("qualified net capital g~i~s'~ by permitting a deduction in computing adjusted gross income-equal to 30 percent of the lesser of (1) the net capital gain for the taxable year or (2) the net capital gain for the taxable year taking into account only gain or loss from sales or exchanges during the September 14, 1989 through December 31, 1991 period. The 30 percent exclusion would not be allowed, however, in computing alternative minimum taxable income. The determination of whether a RIC shareholder was entitled to the 30 percent exclusion on capital gain dividends would be based on when the RIC disposed of the property giving rise to the gain. Thus, gains realized by a RIC before September 14, 1989 would be fully taxable regardless of whether they were distributed to shareholders before or after September 14, 1989. conversely, gains realized by a RIC between September 14, 1989 and December 31, 1991 would be eligible for the 30 percent exclusion at the shareholder level regardless of when these gains were distributed to shareholders. 5. Phase Out of 15 Percent Rate and PersQna1 Exemption (Attachment 5). The bill would also provide that any net capital gain on assets sold or exchanged after September 13, 1989 would not be taken into account under the phase out of either the 15 percent rate or the personal exemption. Thus, the maximum tax rate on realized capital gains would be 19.6 percent (70 percent of 28' percent) for assets sold or exchanged during the period beginning september 14, 1989 and ending December 31, 1991 and would be 28 percent for assets sold or exchanged after December 31, 1991. 6. Indexing (Attachment 6). The bill would also permit individuals to index the basis of certain assets acquired after December 31, 1991. In the case of RIC investments, indexing adjustments could be made at both the RIC level and the shareholder level. A. Indexing in General . . The bill would provide that for purposes of determining gain (but not loss) on the sale or disposition by an individual of an "indexed asset" which was held for more than one year, the indexed basis of the asset would be substituted for its adjusted basis. The term "indexed asset" would be defined generally as any stock in a corporation and any tangible property which was a capital asset or used in a trade or business and was acquired after December 31, 1991. The term "indexed asset" would not include, among other things, debt, collectibles, options, certain - 3 - preferred .toqk (i.e., stock which was fixed and preferred as to dividends~aid- not participate in corporate growth to any significant extent), and stock in a foreign corporation unless that stock was regularly traded on a u.s. national or regional exchange. The. indexed basis for any asset would be the asset's adjusted basis multiplied by the "applicable inflation ratio." To compute the applicable inflation ratio, the consumer price index ("CPI") for the calendar year preceding the calendar year in which the disposition took place would be divided by the CPI for the calendar year preceding the calendar year in which the taxpayer's holding period for such asset began. The applicable inflation ratio would be disregarded if it were less than 1. A "simplifying convention" would be provided in the bill whereby all assets disposed of during a calendar year would be treated as disposed of on the last day of that year. Under this convention, to the extent that the date of disposition were moved forward, the date of acquisition would correspondingly be moved forward. For example, if an asset were acquired on 9ctober 1, 1991 and sold 33 months later on June 30, 1994, under the convention the asset would be treated as sold on December 31, 1994 and acquired on April 1, 1992 (i.e., 33 months prior to the deemed disposition date). Consequently, indexing would be permitted to the extent that the CPI increased from 1991 (the calendar year preceding the year of the deemed acquisition) to 1993 (the calendar year preceding the year of the deemed disposition). . The bill would also provide two special short sale rules. First, if an indexed asset were sold short and the sale was not closed for more than one year, the amount realized would be increased by the applicable inflation ratio. Second, if a taxpayer sold short property substantially identical to an asset held by the taxpayer, neither the asset held by the taxpayer nor the substantially identical property would be treated as an indexed asse~ during the short sale period. Another special rule would reduce the applicable·inflation ratio for periods during which an asset (e.g., 'convertible debt converted into common stock) was not an indexed asset. B. Special Indexing Rules for RICs and Their Shareholders For RIC investments, indexing would generally apply at both the RIC level and at the RIC shareh~lder level. A RIC would be permitted to index its basis in all indexed assets. Indexing would apply in the computation of both the RIC's taxable income and its earnings and profits. Thus, a RIC would be required generally to distribute to_its shareholders only its gains after indexing. Indexing would not apply, however, in computing income - 4 - for purpo~e~ ~f the RIC qualification tests (e.g., sections 851(b) (2)~ -(b)-(3». In addition, to the extent that a RIC retained capital gains that were not designated pursuant to section 852(b) (3) (D), the corporate level tax imposed under section 852(b) (3) (A) would be increased to eliminate the benefit of the indexing adjustment. Because a RIC's corporate shareholders would not be eligible for indexing, the bill would effectively treat these shareholders as having received distributions equal to what they would have received had indexing adjustments not been made at the RIC level. A RIC's individual shareholders would be permitted in general to index their RIC stock for any calendar month in the same ratio as the fair market value of the indexed assets held by the RIC at the close of such month bore to the fair market value of all of the RIC's assets at the close of such month. Under safe harbors in the bill, the ratio for any month would be deemed to be 100 percent if the actual ratio for the month was 90 percent or more. Cnnversely, if the ratio for any calendar month were 10 percent or less, the ratio for such month would be zero. IV. RIC-RELATED PROVISIONS 7. Disqualified Discount Obliaations (Attachment 7). The bill would treat as preferred stock, both for purposes of the issuer and the holder of such an instrument, any "disqualified discount obligation", i.e., any debt instrument (1) with a maturity date of more than 5 years from the date of issue, (2) with a yield to maturity that equalled or exceeded the sum of the applicable Federal rate for the calendar month in which the obligation was issued plus 5 percentage points, and (3) which had "significant __~rigina1 issue discount". In addition, the provision would bifurcate any disqualified discount obligation that paid current interest and treat such obligation as two instruments, a debt instrument and preferred stock, for-Federal income tax purposes. The Treasury Department would be given authority to prescribe any regulations that may be appropriate to carry out the provision's purpose. This provision would be effective generally for instruments issued after July 10, 1989. An assumption by a taxpayer of an instrument issued by another taxpayer would be treated as a new issuance for purposes of this rule. The effective date rule WOUld, however, be subject to exceptions, inclUding one which would exempt from the rule instruments issued pursuant to the terms of a debt instrument_that was issued befor~the effective - 5 - date, suc~-~s_a payment-in-kind (PIX) bond issued after July 10, 1989 as iBterest on a PIX bond issued before July 10, 1989. 8. Disqualified Preferred stock (Attachment 8). The bill would also amend section 1059 to treat as an extraordinary dividend any dividend with respect to "disqualified preferred stock", i.e., a stock which (1) when issued, had a dividend rate which declined (or could reasonably be expected to decline) in the future, (2) had an issue price that exceeded its liquidation rights or its stated redemption price, ~ (3) 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. Treatment of a dividend as extraordinary would 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 would apply generally to stock issued after July 10, 1989. 9. Debt/Equity Regulatory Authority (Attachment 9). The bill would clarify the Treasury Department's regulatory authority under section 385 to treat an instrument as part stock and part debt. This authority would apply prospectively only with respect to instruments issued after public guidance was released. 10. Dividends Paid By Members of Consolidated Group (Attachment 10). Section 1503 would be amended by the bill to require that any distribution made by a member of an affiliated group of corporations filing a consolidated return to a nonmember shareholder, such as a RIC, be treated as a dividend only to the extent that the consolidated group as a whole, and.not the corporation paying the dividend, had earnings and profits. Thus, in general, if a member of a group had current or accumulated earnings and profits but the group as a whole did not, a distribution by the member would not constitute a dividend. Numerous special rules regarding earnings and profits would also be provided. The provision would determine the earnings and profits of the group on a consolidated basis for periods after July 10, 1989 and would be generally effective for distributions after July 10, 1989. 11. Reduction in Built-in Loss" Threshold (Attachment 11). The bill would restrict the use of built-in losses for purposes of the section 382 limitation on net operating loss - 6 - carryforw~rds.and, by cross-reference, the section 383 limitation on capit~ss carryforwards. Under present law, these limitations apply only if the net unrealized built-in loss exceeds 25 percent of the fair market value of the corporation's assets. Under the bill, these limitations would apply if the net unrealized built-in loss exceeded the lower of (1) 15 percent of the fair ~arket value of the corporation's assets or (2) $10 million. This provision would be generally effective for ownership changes and acquisitions after July 10, 1989 in taxable years ending after such date. 12. Taxation of Certain stock Gains of Foreign Persons (Attachment 12). Under the bill, a foreign investor who owned 10 percent of any domestic corporation would genera~ly be taxed on gains on the disposition of stock in such corporation. Any withholding agent, i.e., the last U.s. person to have control of the amount realized on the disposition, could have withholding obligations with respect to stock disposed of by a nonresident alien individual or foreign corporation. Generally, the provision would be effective for dispositions after December 31, 1989. The withholding provisions, however, would not apply to any disposition before the date which was six months after the date of enactment of the bill. In addition, the provision would not apply until July 10, 1992 in any case where its application would conflict with an obligation of the United states under an income tax treaty. 13. Foreign currency Gains and Losses (Attachment 13). The bill would provide 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 characterization applies pursuant to section 988 to gains and losses from trading section 1256 contracts, the gains and losses would not be considered gain or loss from the sale or exchange of a capital asset pursuant to section 1256(f) (3). This technical correction would have the same effective date as the Technical and Miscellaneous Revenue Act of 1988 provision it would amend, i.e., it would apply to forward contracts, -futures contracts, options and similar instruments entered into or acquired after October 21, 1988. V. CIVIL TAX PENALTY REFORM The tex bill would also make numerous changes to the Code's civil tax penalty provisions. - 7 - 14. Information Reporting penalty System (Attachment 14). Under present law, separate Code sections provide 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 House Ways and Means committee bill would restructure 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 chanqes to the information reportinq penalty provisions included in the bill would be significant. First, the bill would make two changes to the TIN reporting provisions. Unlike present law, where the $50 per failure penalty for filinq a return with no TIN or for including an incorrect TIN on a dividend return or statement is not limited by any ceiling, the - bill would cap the penalty for a payor at $100,000 per calendar year. A second chanqe would modify the conditions that must be satisfied to assert a defense to the $50 penalty. Under present law, only a payor who has exercised "due diligence" may assert a defense aqainst the imposition of the penalty. Under the bill, no penalty would be imposed with respect to any such failure which was shown to be due to "reasonable cause" and not to "willful neglect." Due diligence is described in the committee Report 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 siqnificant mitigating factors are present, such as the fact that a person has an established history of complying with the information reportinq requirements." The present law penalties of $50 for failing to file informatio~ returns with the IRS and for failing to furnish payee statements to shareholders would be combined under the bill 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 failinq to furnish correct payee statements to shareholders. The bill would cap the $50 penalty for failing to file correct information returns to the IRS at $250,000 and would cap the $50 penalty for failing to furnish correct payee statements to shareholders at $100,000. As under present law, these failure to file and failure to furnish penalties would not be imposed with respect to any failure shown to be due to reasonable cause and not to willful neglect. - 8 - In addi~ion, the penalty for failure to file correct informati~~eturnswith the IRS would be modified under the bill I to provide a slidinq scale penalty schedule. Thus, payors would be encouraqed to file correct information returns even thouqh such returns miqht be filed after the prescribed filinq date. The slidinq scale penalty system would not apply to either failures to include correct TINs on information returns or statements or failures to provide correct payee statements to shareholders. The bill would also provide that when incorrect information returns filed with the IRS were corrected on or before August 1 of that year, the oriqinal r~turn would be treated as havinq been filed with the correct information. This relief would be limited, however, to the qreater of 10 returns or one-half of one percent of the total number of returns that were required to be filed by the person durinq the calendar year. Failures to include correct TINs on information returns and statements and failures to provide correct payee statements to shareholders would not be eliqible for this relief. Present law rules for failures that are due to intentional- disreqard of the filinq requirements would be retained under the bill for failures to file correct information returns with the IRS and would be added for failures to furnish correct payee statements to shareholders. As under present law, no special rules would apply under the bill to any intentional disreqard of the requirements to supply TINs on returns filed with the IRS or on statements sent to shareholders. The information reportinq provisions of the bill would qenerally apply to information returns and payee statements the due date for which (determined without reqard to extensions) was after December 31, 1989. 15. Delinquency Penalties (Attachment 15). The bill would modify the penalty for the failure to make timely deposits of tax in order to encouraqe depositors to correct their failures. Under present law, a penalty may be imposed eq9al to 10 percent of the amount of the underpaYment unless it is shown that the failure is due to reasonable cause and not willful neqlect. The bill would impose a four-tier penalty structure under which a depositor's penalty would increase the lonqer the underpaYment remained uncorrected. As under present law, no penalty would be imposed if the failure to make a timely deposit were due to reasonable cause and not willful neqlect. This modification would apply to deposits that were required to be made after December 31, 1989. - 9 - In addit~o~, the bill would provide that in cases where a tax on t~S. income of a foreiqn person was required to be withheld, but was not in fact withheld, and the person who would have been entitled to a credit for any tax withheld satisfied its proper tax liability, the withholdinq aqent would remain liable for any penalties and additions to tax otherwise applicable for failure to withhold. This modification would apply to failures to deduct and withhold taxes after December 31, 1989. 16. Administrative Recommendations to the IRS (Attachment 16). The House Ways and Means Committee included in their Report numerous administrative recommendations to the IRS reqardinq the information reportinq system. The first recommendation, for example, states that "[t]he IRS should adopt a clear policy of workinq with the third-party payor community to assure accurate and timely filinq of information, in a format that is usable by the IRS -and the taxpayer without unduly burdeninq the third party that is required to provide this information." Many of the other recommendations are also relevant. * * * We will keep you informed of developments reqardinq this leqislation. Keith D. Lawson Assistant General Counsel Attachments - 10 -

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