MEMO# 9111

August 1, 1997

TAXPAYER RELIEF ACT OF 1997 APPROVED BY CONGRESS

1 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, and the memoranda cited therein, for descriptions of the earlier House and Senate versions of this bill. August 1, 1997 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 TRANSFER AGENT ADVISORY COMMITTEE No. 36-97 RE: TAXPAYER RELIEF ACT OF 1997 APPROVED BY CONGRESS

____ Congress yesterday gave final approval, by votes of 389-43 in the House and 92-8 in the Senate, to the "Taxpayer Relief Act of 1997," the tax portion of the Balanced Budget Act. The Act will become law when signed later this month by the President. This memorandum discusses those tax (non-pension-related) provisions of the Act of interest to regulated investment companies ("RICs") and their shareholders.1 A separate Institute memorandum will discuss the Act's pension-related provisions. I. Repeal of the 30 Percent Test (Attachment I) We are particularly pleased to report that the Act includes the Institute's number one tax legislative priority: repeal of the 30 percent test of Internal Revenue Code ("Code") section 851(b)(3), effective for taxable years beginning after date of enactment. II. Capital Gains Provisions A. Maximum Rate of Tax on Net Capital Gains of Individuals (Attachment II-A) The Act modifies significantly the taxation of capital gains realized by individuals. These changes apply for purposes of both the regular income tax and the minimum tax. A new maximum tax rate of 20 percent (or 10 percent for individuals in the 15 percent rate bracket) is provided for "adjusted net capital gains" with respect to assets sold after May 6, 1997 and held for more than 18 months (or 12 months in the case of assets sold after May 6, 1997 and before July 29, 1997). The term "adjusted net capital gain" is defined as net capital gain (i.e., the excess of net long-term capital gain for the taxable year over net short-term capital loss for

2 The Act does not change any of the rules for determining whether a gain or loss is "short-term" or "long-term." Thus, for example, gain on an asset held for more than one year (such as for 13 months) remains long-term. 3 A foreign corporation is treated as publicly traded if its stock is regularly traded on a national securities exchange which is registered with the Securities and Exchange Commission, the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934 or any other exchange or market that the Treasury Department determines has rules sufficient to ensure that the market price represents a sound fair market value. - 2 - such year)2 without regard to, among other things, "mid-term gain." This new tax concept, "mid-term gain," is determined

by taking into account only the gain or loss from property held for more than 12 months but not more than 18 months and sold after July 28, 1997. The new rules for "adjusted net capital gains," however, do not affect the tax rate on gains from the sale of assets sold after July 28, 1997 that were held for between 12 and 18 months (the new "mid-term gains"); these gains remain taxable at ordinary income rates, subject to a maximum rate of 28 percent. A new maximum tax rate of 18 percent (or 8 percent for individuals in the 15 percent bracket) is provided for "qualified 5-year gains," which are net gains on assets held for more than 5 years and sold after December 31, 2000; in the case of the 18 percent rate only, the asset also must be acquired after December 31, 2000. Readily tradable stock held on January 1, 2001 by a taxpayer not in the 15 percent bracket can become eligible for qualified 5-year gain treatment (if held for an additional 5 years) if the taxpayer elects, on an asset-by-asset basis, to treat the stock as sold and repurchased at the close of the next business day after January 1, 2001 for a price equal to its closing market price. Under the Act, any such gain is treated as received on the date the asset is deemed sold and recognized notwithstanding any provision of the Internal Revenue Code; any resulting loss on the deemed sale is not allowed for any year. The Act provides the Treasury Department with authority to prescribe regulations (including reporting requirements) applying these new rules to, among other things, sales and exchanges by (1) RICs of portfolio securities and (2) RIC shareholders of RIC shares. The Act's changes 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-through entities, the determination of when gains and losses are properly taken into account is made at the entity level. B. Qualified Small Business Stock (Attachment II-B) The Act modifies the treatment of disposition gain on qualified small business stock by providing individuals with a 60-day period following the sale or exchange of such stock held for more than 6 months to roll over the gain in a tax-free transaction to another investment in qualified small business stock. This rollover provision applies to sales occurring after date of enactment. Other provisions in the Senate bill, which would have increased the demand by RICs for qualified small business stock, were not included in the Act. III. Passive Foreign Investment Companies ("PFICs") (Attachment III) A. Mark-to-Market Election The Act provides any taxpayer holding shares of "marketable" passive foreign investment companies ("PFICs") with an election to mark that stock to market at the close of the taxpayer's taxable year. RICs making the election will mark their PFICs to market at taxable year-end for income tax purposes and at October 31 for purposes of the excise tax minimum distribution requirements of Code section 4982. The provision is 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) is treated as marketable stock. Once a taxpayer makes a mark-to-market election with respect to a stock, the election applies to that stock for all subsequent years, unless the IRS consents to a revocation of the election. Any PFIC mark-to-market gain is treated as ordinary income. PFIC mark-to-market losses are allowable as ordinary losses to the extent of net mark-to-market gains previously included, under the statute, with respect to such stock. The nondeductible "interest charge" that otherwise would be imposed on a RIC that held PFIC stock prior to the provision's effective date is not imposed if the RIC has elected mark-to-market treatment (presumably under proposed regulations previously issued by IRS) for the prior taxable year. B. Valuation of Assets for PFIC Determination The Act also modifies the definition of a PFIC (under the asset test) by providing that, with respect to a publicly-traded foreign corporation,3 the total value of the publicly-traded foreign corporation's assets is equal to the sum of the aggregate fair market value of its outstanding stock plus its liabilities. This change, which was in neither the House nor the Senate bill, is 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. 4 Regulatory authority provided by the Act to treat certain foreign taxes as not subject to this provision is intended by the Congress to address internal withholding taxes imposed by a foreign country on persons that do business in the foreign country. - 3 - IV. Foreign Tax Credit Provisions A. Simplified Procedures for Claiming Foreign Tax Credits (Attachment IV-A) The Act simplifies the procedures by which investors 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, can claim credits against US tax for these amounts by reporting them directly on their IRS Form 1040 income tax returns without first completing the separate, detailed form (IRS Form 1116) otherwise used to establish eligibility for the credits. This provision applies to taxable years beginning after December 31, 1997. B. Holding Period for Claiming Foreign Tax Credits (Attachment IV-B) The Act generally denies 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 holds the stock (without protection from risk of loss) on the dividend entitlement date and for at least 15 additional days immediately before and/or thereafter.4 Any taxpayer who fails to satisfy this 16-day holding period requirement is 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 applies in determining whether (1) the RIC holds each of its foreign securities long enough to flow through "creditable" foreign taxes and (2) the RIC shareholder holds 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 Act requires 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 are not creditable because the RIC did not meet this holding period requirement. 5 The Conference Agreement provides that an actively traded trust instrument generally is treated as stock unless substantially all (by value) of the property held by the trust is "straight debt." 6 The Conference Agreement clarifies that a debt instrument must entitle the holder to receive an unconditional principal amount and not be convertible (directly or indirectly) into stock of the issuer to qualify as "straight debt." 7 The Conference Agreement provides that an agreement that is not a contract for purposes of applicable contract law is not intended to be treated as a forward contract. Thus, contingencies to which the contract is subject generally will be taken into account. 8 The Act also allows securities traders, commodities traders and commodities dealers to elect application of the mark-to-market rules of Code section 475 formerly applicable only to securities dealers. - 4 - V. Appreciated Positions in Personal Property A. Constructive Sale Treatment for Appreciated Financial Positions (Attachment V-A) The Act requires a taxpayer holding an "appreciated financial position," defined generally to include an appreciated position in any stock,5 debt instrument (other than "straight debt")6 or partnership interest, to recognize gain upon entering into a "constructive sale." A taxpayer holding property subject to the constructive sale rule is treated as having sold and immediately repurchased the appreciated property and receives a new basis and holding period in the property. If a taxpayer enters into a constructive sale with respect to less than all of his or her appreciated positions in the property, the property deemed sold is determined under the general rules governing actual sales. The term constructive sale includes, among other things, (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 contract7 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, does 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 4758 and transactions subject to the mark-to-market rules of Code section 1256. Transactions that are identified hedging or straddle transactions under other Code provisions (sections 1092(a)(2), (b)(2) and (e), 1221 and 1256(e)) can be subject to the constructive sale provisions. Where either position in such an identified transaction is an appreciated financial position and a constructive sale of such position results from the other position, the constructive sale will be treated as having occurred immediately before the identified transaction. The constructive sale, however, will not prevent qualification of the transaction as an identified hedging or straddle transaction. Where, after the establishment of such an identified transaction, there is a constructive sale of either position in the transaction, gain generally will be recognized and accounted for under the relevant hedging or straddle provision. Pursuant to Treasury regulations, certain transactions may be excepted from the constructive sale provision where the gain recognized would be deferred under an identified hedging or straddle provision. The Act includes a "closed transaction" exception from constructive sale treatment, which is modified by the Conference Agreement to provide similar requirements for any transaction that is closed at any time before the end of the 30th day after the close of the taxable year in which it was entered into (instead of limiting such requirements to transactions closed during the 90-day period ending on such date, as under the House and Senate bills). Under the Act, this exception is available only if, for the 60 days after closing a transaction, (1) the taxpayer holds the appreciated financial position and (2) at no time is the taxpayer’s risk of loss reduced by holding certain other positions with respect to substantially similar or related property. If a transaction that is closed is reestablished in a substantially similar position, the exception applies provided that the reestablished position is closed prior to the end of the 30th day after the close of the taxable year and the above two requirements are met after such closing. The Treasury Department’s regulatory authority is discussed in some detail in the Conference Agreement. For example, Treasury is urged to issue prompt guidance, including safe harbors, with respect to common transactions entered into by taxpayers. The Conferees also recommend that Treasury provide standards for determining which "collar" transactions result in constructive sales, but that the regulations be issued prospectively, except in cases of abuse. Further, the Conferees intend that the circumstances in which a taxpayer’s appreciated financial position or an offsetting transaction may be considered on a disaggregated basis for purposes of the constructive sale determination will be limited to situations where such disaggregated treatment reflects the economic reality of the transaction and is administratively feasible. The Act applies to 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 are not 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. B. Restrictions on Swap Funds (Attachment V-B) The Act restricts 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). The definition of investment 9 Prior to this change, an investment company precluded from the nonrecognition of gain rules of Code sections 351 and 721 was 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]." 10 The Act also extends the statute of limitations with respect to this income to the earlier of (1) 3 years after Treasury is notified that the position has become substantially worthless or (2) 6 years after the date the tax return is filed for the year in which the position became substantially worthless. - 5 - company -- contributions to which may generate capital gain9 -- is expanded by the Act to include any company if more than 80 percent of the value of its assets is attributable to stock and securities, treating the following as stock and securities: 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. VI. Offshore Funds "Principal Office/Ten Commandments" Safe Harbor (Attachment VI) The Act eliminates 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 applies to taxable years beginning after December 31, 1997. VII. Dividends Received Deduction Holding Period Requirement (Attachment VII) The Act makes 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. In general, this change is effective for dividends paid or accrued after the 30th day after date of enactment; the change will not apply for two years following date of enactment, however, with respect to dividends paid on stock that is part of a hedged position entered into before June 9, 1997, so long as the taxpayer identifies the stock and related position within 30 days after date of enactment and continuously maintains the hedged position from June 8, 1997 until the dividend is received. VIII. OID Where Pooled Debt Obligations Subject to Acceleration (Attachment VIII) 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, are extended by the Act to any pool of debt instruments the yield on which may be affected by reason of either prepayments or, to the extent provided in regulations, other events. 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 is required by the Act 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. This provision is effective, in general, for taxable years beginning after date of enactment. IX. Publicly Traded Partnership Exception for "Electing 1987 Partnerships" (Attachment IX) The Act modifies the treatment of so-called "grandfathered" publicly traded partnerships, which were scheduled to become taxable as corporations (rather than treated as partnerships) for taxable years beginning after December 31, 1997. Under the Act, any existing publicly traded partnership taxed as a partnership (other than one that receives this status under the passive-type income exception of Code section 7704(c)(1)) can elect to be treated as an "electing 1987 partnership" and maintain its treatment as a partnership (rather than become taxable as a corporation), for taxable years beginning after December 31, 1997, so long as it pays a tax equal to 3.5 percent of its gross income from the active conduct of trades or businesses (with no offset for tax credits) and does not add a substantial new line of business. X. Gains and Losses from Certain Terminations (Attachment X) The Act modifies 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 -- is extended to all types of property, effective for terminations more than 30 days after date of enactment. Second, the Act treats 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. Finally, the Act includes a provision in neither the House or Senate bill providing that if a taxpayer enters into a short sale of property and the property becomes substantially worthless after date of enactment, the taxpayer must recognize gain as if the short sale were closed on the date the property became substantially worthless.10 To the extent provided in Treasury regulations, similar gain recognition rules also will apply to any option with respect to property, any offsetting notional principal contract with respect to property, any futures or forward contract to deliver property, or with respect to any similar transaction or position that becomes substantially worthless. XI. Limitation on Treaty Benefits for Payments to Hybrid Entities (Attachment XI) The Act provides that a foreign person is not entitled to withholding tax rate reductions under a treaty with a foreign county on income derived through an entity that is treated as a partnership (or is otherwise treated as fiscally transparent) for US tax purposes if (1) the income is not treated for purposes of the foreign country's tax laws as such person's income, (2) the foreign country does not impose tax on an actual distribution of such income from such entity 11 See Institute Memorandum to Tax Members No. 26-97, International Members No. 11-97, Operations Members No. 23-97 and Transfer Agent Advisory Committee No. 33-97, dated July 9, 1997. 12 See Institute Memoranda 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; and to Tax Committee No. 12-97, dated April 1, 1997. - 6 - to such person and (3) the treaty itself does not contain a provision addressing the applicability of the treaty in the case of income derived through a partnership or other fiscally transparent entity. The Conference Agreement grants the Treasury Department regulatory authority to determine, in situations other than the specific situation described in the statute, the extent to which a taxpayer shall not be entitled to US tax treaty benefits with respect to any payment received by, or income attributable to activities of, an entity that is treated as a partnership for US tax purposes (or otherwise is treated as fiscally transparent for such purposes) but is treated as fiscally non-transparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer. The Conferees note that the proposed and temporary regulations issued by Treasury on June 30, 1997, addressing the availability of treaty benefits in cases involving hybrid entities,11 generally are consistent with the Conference Agreement. XII. Delay in Imposition of Penalties for Failure to Make Payments Electronically (Attachment XII) Under the Act, 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 a specified period beginning July 1, 1997, to make them using EFTPS. The penalty moratorium expires under the Act on June 30, 1998. XIII. Provisions from House or Senate Bill That Are NOT in Conference Bill The Act does not include (1) the House proposal to index for inflation the cost basis of certain assets, (2) the House corporate net capital gain alternative tax proposal, (3) most of the qualified small business stock proposals in the Senate bill and (4) the House proposal to generally extend the pro rata disallowance of tax-exempt interest expense rule to all corporations. XIV. Other Provisions Considered But Excluded From Conference Bill The Act also does not include the Treasury Department proposals opposed by the Institute to (1) require that all securities sellers compute cost basis using the average cost method and (2) increase the penalties for failure to file correct information returns.12 * * * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment (in .pdf format) Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute's Information Resource Center at (202)326-8304, and ask for this memo's attachment number: 9111.
