

MEMO# 12378

July 24, 2000

ICI COMMENTS TO IRS ON QUALIFIED 5-YEAR GAIN RULES

[12378] July 26, 2000 TO: TAX MEMBERS No. 21-00 ACCOUNTING/TREASURERS COMMITTEE No. 28-00 TRANSFER AGENT ADVISORY COMMITTEE No. 35-00 RE: ICI COMMENTS TO IRS ON QUALIFIED 5-YEAR GAIN RULES The Investment Company Institute has submitted the attached letter to the Internal Revenue Service urging the Service to address certain implementation issues regarding the qualified 5-year gain rules, which become effective after December 31, 2000. As we previously informed you,¹ Congress included in the Taxpayer Relief Act of 1997 provisions reducing the maximum capital gains tax rate on certain assets held more than 5 years.² We have, for several years, urged the Service to place a guidance project on its business plan to inform taxpayers and the regulated investment company ("RIC") industry of the proper implementation of these rules.³ In the attached letter, we have highlighted certain issues that require immediate attention from the IRS, given the rapidly approaching effective date of the qualified 5-year gain rules. This memorandum summarizes our comments to the Service.

Mark-to-Market Rules A general issue applicable to all individual taxpayers is how they could make a mark-to-market election for assets held on January 1, 2001. We have recommended that taxpayers be permitted to elect to mark their shares to market by attaching an election to their tax returns (Form 1040) filed for 2001. We have likewise recommended that third parties, such as RICs, not be required to be notified of any individual taxpayer mark-to-market election and not have any record-keeping obligations with respect to such an election. Finally, we have recommended that the Service announce that the deemed sale and

¹ See Institute Memorandum to Tax Members No. 27-97, Accounting/Treasurers Members No. 31-97 and the Transfer Agent Advisory Committee No. 36-97, dated August 1, 1997. ² Internal Revenue Code section 1(h)(2), as amended by section 311 of the Taxpayer Relief Act of 1997 (P.L. 105-34), reduces the capital gains tax rates for qualified 5-year gain for individual taxpayers. Under this provision, effective after December 31, 2000, qualified 5-year gain becomes eligible for reduced capital gains rates of 8 percent for taxpayers in the 15-percent tax bracket. In addition, 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 (i.e., tax at an 18 percent rate) if the taxpayer elects, on an asset-by-asset basis, to treat the stock as sold and repurchased (a "mark-to-market election") as of the beginning of 2001 for an amount equal to its fair market value and holds that stock for more than an additional 5 years. Stock purchased on or after January 1, 2001 and held for more than 5 years is eligible for qualified 5-year gain treatment regardless of shareholder tax bracket. ³ See Institute Memorandum to the Tax Committee No. 2-2000, dated January 11, 2000. ² repurchase of securities be disregarded for purposes of the wash sale rules of Code section 1091 with respect to any taxpayer mark-to-market election. An issue specific to RIC portfolios is whether RICs are permitted to mark their own portfolio securities to

market pursuant to the qualified 5-year gain rules. We have urged the Service to clarify that such an election is indeed permitted under the rules. Allowing this fund-level election would enable the full benefit of the statutory provision to inure to taxpayers, as Congress clearly intended, and to ensure that RIC investors receive treatment comparable to the tax treatment of direct investors. We have suggested that RICs make any mark-to-market election on the Form 1120-RIC that is filed for the period including January 1, 2001. Finally, we have recommended that RIC shares fall under the definition of “readily tradable stock,” so that the share valuation for any mark-to-market elections would be determined based on the January 2, 2001 closing price. Distributions of Qualified 5-Year Gains to RIC Shareholders We have suggested to the Service that, while the industry does not necessarily require a published IRS Notice at this time clarifying how RICs should pass through qualified 5-year gains to 15 percent bracket shareholders, IRS Form 1099-DIV for 2001 should be finalized and released as soon as possible and should include a separate box for qualified 5-year gains. In addition, we have suggested that the accompanying instructions state affirmatively that RICs are to report in the qualified 5-year gain box the full amount of gains realized at the entity level after December 31, 2000 on assets held by the RIC for more than 5 years that are distributed to the RIC shareholder receiving the IRS Form 1099-DIV. Shareholders would be responsible for determining whether they are in the 15 percent tax bracket and therefore eligible to treat the identified portion of the capital gain dividend as qualified 5-year gain. We have also suggested that the IRS clarify that no additional requirements should be imposed on the ability of a RIC shareholder to receive the benefit of the qualified 5-year gain rules. In particular, we have urged that RIC shareholders not be denied the benefit of sale of qualified 5-year gains at the entity level based on the shareholder’s individual holding period of their shares. If you have any questions regarding our comments to the IRS or about the qualified 5-year gain rules, please contact the undersigned at (202) 326-5821. Naomi Gendler Camper Assistant Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 12378. ICI Members may retrieve this memo and its attachment from ICINet (<http://members.ici.org>). Attachment (in .pdf format)