MEMO# 10300

September 21, 1998

HOUSE WAYS AND MEANS COMMITTEE PROVIDES 20 PERCENT MAXIMUM TAX RATE FOR ESSENTIALLY ALL 1998 CAPITAL GAIN DIVIDENDS

1 See Institute Memorandum to Tax Members No. 18-98, Accounting/Treasurers Members No. 16-98, Operations Members No. 17-98, Closed-End Investment Company Members No. 19-98, Unit Investment Trust Members No. 14-98, International Members No. 13-98, Transfer Agent Advisory Committee No. 33-98 and Broker/Dealer Advisory Committee No. 10-98, dated June 26, 1998. 2 See Institute Memorandum 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 and Transfer Agent Advisory Committee No. 36-97, dated August 1, 1997. [10300] September 21, 1998 TO: TAX MEMBERS No. 29-98 ACCOUNTING/TREASURERS MEMBERS No. 23-98 CLOSED-END INVESTMENT COMPANY MEMBERS No. 27-98 UNIT INVESTMENT TRUST MEMBERS No. 20-98 OPERATIONS MEMBERS No. 23-98 TRANSFER AGENT ADVISORY COMMITTEE No. 58-98 RE: HOUSE WAYS AND MEANS COMMITTEE PROVIDES 20 PERCENT MAXIMUM TAX RATE FOR ESSENTIALLY ALL 1998 CAPITAL GAIN DIVIDENDS ____ The House Ways and Means Committee has approved H.R. 4579, the "Taxpayer Relief Act of 1998" (hereinafter "the Ways and Means Committee bill" or "the bill"). Among other things, the bill would modify the capital gains holding period change that was enacted earlier this year as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "1998 Act").1 While President Clinton has indicated that he will veto the bill (in its current form), the Treasury Department does not object to treating the capital gains provision discussed below as a "technical correction." This memorandum discusses the following three provisions of interest to regulated investment companies ("RICs") and their shareholders: (1) a technical correction to the capital gains rules; (2) a partial exclusion from income for dividends and interest; and (3) the treatment of certain deductible liquidating distributions made by real estate investment trusts ("REITs") and RICs. Technical Correction to Capital Gains Rules (Attachment A) The 1998 Act modified the taxation of capital gains by reducing from 18 months to one year the holding period requirement for the 20-percent maximum capital gains rate that was enacted as part of the Taxpayer Relief Act of 1997 ("the 1997 Act").2 The 1998 Act's change applies to amounts "properly taken into account" after December 31, 1997. Under the 1998 Act, any gain on the disposition after 1997 of RIC shares held for more than 12 months is taxed at a 20 percent maximum rate. However, under the 1998 Act, any portion of a RIC capital gain dividend paid during 1998 that is

attributable to 3 Some RICs may have “collectibles gain” that remains taxable at a 28 percent maximum rate and/or “unrecaptured section 1250 gain” that remains taxable at a 25 percent maximum rate. long-term gain on RIC assets sold during 1997 (but not held by the RIC for more than 18 months) would remain taxable at a 28 percent maximum rate. The Ways and Means Committee bill would modify the effective date for the 1998 Act’s capital gains change so that, in essentially all instances, RIC capital gain dividends paid to shareholders during 1998 would be taxed at a maximum rate of 20 percent.3 Thus, this 20-percent rate treatment for assets that were sold during 1997 after being held for more than one year but not more than 18 months would apply to (1) gains and losses recognized directly by the RIC and (2) amounts properly taken into account by the RIC, by reason of holding (directly or indirectly) an interest in another RIC or in a REIT, to the extent that such amounts are eligible for 20-percent rate treatment under the bill. While the bill, as drafted for Committee consideration, did not extend this treatment to gains recognized by RICs from investments in partnerships (such as master funds in the master-feeder fund structure), the legislative drafters have agreed in principle to provide comparable treatment for RIC investments in master funds. Thus, for example, gain on an asset sold by a master fund on November 15, 1997, after being held by the master fund for 15 months, would be eligible for 20-percent rate treatment if distributed by a feeder fund RIC to its shareholders after December 31, 1997. Partial Exclusion for Dividends and Interest (Attachment B) The Ways and Means Committee bill also would provide individuals with an exclusion from income for up to $200 ($400 for married couples filing jointly) of combined dividends and interest received in a taxable year. This proposal would be effective for taxable years of individuals beginning after December 31, 1998. The income exclusion would be provided by proposed new section 116. Distributions by RICs would be eligible for the exclusion, pursuant to proposed new section 116(c), subject to limitations provided by section 854 (as modified by the bill). For these purposes, the term “dividend” would exclude in all cases a RIC capital gain dividend (from assets held for more than one year). In addition, the portion of a RIC’s ordinary dividend that is attributable to the RIC’s short-term capital gains would be excluded from eligible dividend treatment unless the aggregate dividends and interest received by a RIC during the RIC’s taxable year equal 95 percent or more of its gross income (computed without regard to the RIC’s net long-term capital gain). A RIC would be required by section 854(b)(2) to designate the amount of its dividend that qualified for the section 116 exclusion in a written statement to shareholders mailed not later than 60 days after the close of its taxable year. Treatment of Certain Deductible REIT/RIC Liquidating Distributions (Attachment C) The Ways and Means Committee bill also would address a transaction that was entered into by certain REITs that were owned at least 80 percent by one corporate shareholder; in this transaction, the REIT would liquidate and receive a deduction for certain amounts paid to its parent, but without a corresponding inclusion of income to the parent. Because both REITs and RICs may take a dividends paid deduction for amounts distributed in liquidation that are properly chargeable to earnings and profits, the provision also would apply to 80-percent owned RICs. Under the bill, any amount for which a liquidating REIT or RIC may take a dividends paid deduction, with respect to an otherwise tax-free liquidating distribution to an 80-percent corporate owner, would be includable in the recipient corporation’s income as a dividend. The provision would be effective for distributions made on or after May 22, 1998, regardless of when the plan of liquidation was adopted. The provision would have no other effect on the tax treatment of the distribution to the parent corporation or to the REIT or RIC. Thus, for example, the liquidating REIT or RIC would not recognize gain (if any) on the liquidating distribution and the recipient corporation would hold the distributed assets at a carryover basis. Keith D. Lawson Senior Counsel Attachment 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 Library Services Division at (202)326- 8304, and ask for this memo's attachment number: 10300.