DESCRIPTION OF H.R. 2735

RELATING TO

REGULATED INVESTMENT COMPANIES

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on September 17, 1991

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

September 13, 1991

JCX-16-91

CONTENTS

INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on September 17, 1991, on H.R. 2735, relating to the tax treatment of regulated investment companies.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of H.R. 2735. H.R. 2735 was introduced by Mr. Rostenkowski, and others, on June 25, 1991.

Part I of the pamphlet is a summary. Part II provides a description of the provisions of H.R. 2735, including present law, explanation of the bill, and effective dates.

---

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, Description of H.R. 2735 Relating to Regulated Investment Companies (JCX-16-91), September 13, 1991.

I. SUMMARY

Present Law

A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. The Internal Revenue Code (the "Code") provides conduit treatment by permitting a RIC to deduct dividends paid to its shareholders in computing its taxable income.

To qualify as a RIC, a corporation must elect such status and must satisfy certain tests (Code sec. 851(b)). In particular, a corporation must derive less than 30 percent of its gross income from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held less than 3 months (the "short-short" or "30-percent" test) (sec. 851(b)(3)). A corporation also must derive at least 90 percent of its gross income from certain specified sources, generally investments in stocks, securities or currencies (the "90-percent" test) (sec. 851(b)(2)).

Brokers[2] are required to report to the Internal Revenue Service the gross proceeds from sales and exchanges by customers (sec. 6045). Brokers are also required to give each customer a written statement containing that information by January 31 of the year following the calendar year the transaction occurred.

H.R. 2735

H.R. 2735 would repeal the short-short test and would exclude certain reimbursements from the 90-percent test. The bill also would require brokers that are currently required to report gross proceeds on sales or exchanges of mutual fund shares to report basis information on the same information return.

---

[2] Under section 6045, "broker" is defined to include dealers, barter exchanges, and any other person who, for a consideration, regularly acts as a middleman with respect to property or services. Under the regulations, the term is defined to include mutual funds that deal directly with customers (i.e., mutual funds that stand ready to redeem their shares). The term "broker" has this meaning throughout this pamphlet.

II. EXPLANATION OF THE BILL

1. Repeal the short-short test for regulated investment companies (sec. 1 of the bill and sec. 851(b)(3) of the Code)

Present Law

A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. The Internal Revenue Code (the "Code") provides conduit treatment by permitting a RIC to deduct dividends paid to its shareholders in computing its taxable income.

A RIC is a domestic corporation which, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (Code sec. 851(a)).

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). In particular, a corporation must derive less than 30 percent of its gross income from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held less than 3 months (the "short-short test") (sec. 851(b)(3)).

Explanation of Provision

The bill would repeal the short-short test.

Effective Date

The provision would be effective for taxable years ending after the date of enactment.

2. Require brokers and mutual funds to report basis to customers (sec. 2 of the bill and secs. 1012 and 6045 of the Code)

Present Law

Information returns

Brokers[3] are required to report to the Internal Revenue Service the gross proceeds from sales and exchanges by customers (sec. 6045(a)). Brokers also must give each customer a written statement containing that information by January 31 of the year following the calendar year the transaction occurred (sec. 6045(b)).[4]

Gain or loss from the sale of mutual fund shares

A taxpayer who sells or exchanges mutual fund shares is required to report the gain or loss along with any other capital gains or losses. A taxable sale or exchange includes a direct redemption or sale, a check written on a fund, or exchanges from one fund into another fund.

The amount of gain or loss is the difference between the taxpayer's adjusted basis in the shares and the amount the taxpayer realized from the sale or exchange (sec. 1001). In general, a taxpayer's adjusted basis is his original cost (including any sales charges or "load") or other basis adjusted for such things as wash sales and return of capital distributions. The amount a taxpayer realizes from a disposition of shares is the money and value of any property received for the shares minus expenses (such as sales commissions, sales charges, or exit fees).

A taxpayer who sells any of his shares may choose one of three methods to determine the adjusted basis of the shares that were sold (Treas. Reg. secs. 1.1012-1(c) and (e)):

---

[3] Under section 6045, "broker" is defined to include dealers, barter exchanges, and any other person who, for a consideration, regularly acts as a middleman with respect to property or services. Under the regulations, the term is defined to include mutual funds that deal directly with customers (i.e., mutual funds that stand ready to redeem their shares). The term "broker" has this meaning throughout this pamphlet.

[4] Brokers are required to use Form 1099-B, Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions (or an IRS-authorized substitute) for these reporting purposes.

(1) the first-in, first-out (FIFO) method requires the taxpayer to assume that the first shares sold were the first ones purchased by the taxpayer;

(2) the specific identification method permits the taxpayer to identify exactly which shares were sold--but the method is available only if, at the time of sale, the taxpayer specified to the broker the particular shares to be sold and the broker confirms such specification in a written document within a reasonable time after the sale; or

(3) the average cost method permits the taxpayer to calculate his gain or loss based on the average price he paid for his shares. The average cost method may be determined either by the single category method (which uses the average cost of all of the taxpayer's shares and determines the holding period for the shares that are sold on a first-in first-out basis) or the double category method (which separates the taxpayer's shares into long-term and short-term holdings and provides a separate average cost for each category). A taxpayer may elect the average cost method by attaching a statement to his return. Once the taxpayer elects the average cost method, the taxpayer must use that method for all of his accounts in that fund.

Explanation of Provision

Information returns

In general.--The bill would require brokers that are currently required to report gross proceeds on sales or exchanges of mutual fund shares to report basis and holding-period information on the same information return. Those brokers that are not required to report gross proceeds, such as money market mutual funds, would not be required to report basis information.

Required basis information.--For each sale or exchange, a broker would be required to report the basis of the shares that have been sold and the portion of the gross proceeds for the shares that are held for more than 1 year. Basis would be determined using the single-category average cost basis method (and not the double-category). The bill also would provide the Secretary of the Treasury authority to determine the manner in which basis and holding period are to be reported. Such authority would include the authority to require brokers to take into account wash sales, return of capital distributions, and other events that might affect a basis calculation.

Multiple accounts.--The bill would require the basis calculation to be done on an account-by-account basis. If an individual holds shares in two separate accounts with a mutual fund, then a separate basis calculation would be done for each account. In addition, if a customer holds shares in two mutual funds through a securities broker (rather than directly through the mutual funds themselves), the shares for each mutual fund (i.e., for each position) would be considered separate accounts for purposes of these rules.

Due date of returns.--Under the bill, information returns would be required to be sent to shareholders by January 31, which is, under present law, the same date by which the information returns for gross proceeds must be provided to taxpayers. The bill contemplates that amended basis information returns may be necessary in certain cases (such as certain wash sales).

If a broker holds shares in a mutual fund as a nominee for another person and such shares are transferred to another broker, the old broker also would be required by the bill to furnish the new broker the information necessary for the new broker to meet the information-reporting requirements.

Gain or loss from the sale of mutual fund shares

The bill generally would require a taxpayer to calculate basis and adjustments to basis as under present law. However, unless a taxpayer elects otherwise, a taxpayer would determine basis for mutual fund shares by using the average basis of all of the shares of the account from which a sale or exchange was made (which generally would be the amount required to be reported by the broker).

Under the bill, a taxpayer could elect a method other than average basis (i.e., FIFO or specific identification) if he made such an election on his return for the first taxable year in which a sale from the account occurs. In addition, under the bill, a taxpayer could elect different methods for different accounts in the same fund.

Effective Date

The provision would be effective for mutual fund shares held in accounts opened on or after January 1, 1993. If prior to the effective date a taxpayer holds shares in mutual fund B in an account maintained by a securities broker and holds shares in mutual fund F directly from the fund, additions to either of those positions after January 1, 1993, would not trigger the basis reporting requirement. If, however, after January 1, 1993, the taxpayer purchased shares in mutual fund F through the securities broker, or through a new account opened with mutual fund F, a new position would have been opened and basis reporting would be required on that new position.

The provision would not be applicable, however, to shares in an account that includes shares not acquired by purchase. Thus, the provision would not apply to shares in an account opened after January 1, 1993, that includes shares that had been acquired by gift. The basis in such shares would be determined as under present law.

3. Modify the 90-percent test for regulated investment companies (sec. 3 of the bill and sec. 851(b)(2) of the Code)

Present Law

In order to qualify as a regulated investment company ("RIC"), a corporation must derive at least 90 percent of its gross income from certain specified sources, generally investments in stocks, securities, or currencies (the "90-percent" test) (sec. 851(b)(2)).

Mutual fund advisors sometimes reimburse a RIC for costs already incurred by the RIC. Such reimbursements may be treated as gross income to the RIC under present law and thus may affect the application of the 90-percent test. By contrast, gross income generally is not created if a mutual fund advisor agrees to limit its fees to the RIC prior to charges being incurred.

Explanation of Provision

The bill would provide that any amount included in income by reason of any reimbursement or any other payment with respect to the expenses of a corporation is not treated as gross income under the 90-percent test.

Effective Date

The provision would apply to taxable years ending after the date of enactment.