

Section 854.—Limitations Applicable to Dividends Received From Regulated Investment Company

(Also: § 871, § 852.)

Designation of dividends; regulated investment company (RIC). This ruling provides guidance that allows a RIC, in making the dividend designations permitted by sections 852, 854, and 871 of the Code, to designate the maximum amount permitted under each provision even if the total amount so designated exceeds the total amount of the RIC's dividend distributions. It also allows individual shareholders of the RIC who are U.S. persons to apply designations to the dividends they receive from the RIC that differ from designations applied by shareholders who are nonresident aliens.

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ISSUES

(1) In making the dividend designations permitted by §§ 852(b)(3)(C) and (b)(5)(A), 854(b)(1) and (2), and 871(k)(1)(C) and (2)(C) of the Internal Revenue Code, may a regulated investment company ("RIC") designate the maximum amount permitted under each provision even if the aggregate of all of the amounts so designated exceeds the total amount of the RIC's dividend distributions?

(2) May individual shareholders of the RIC who are United States persons apply designations to the dividends they receive from the RIC that differ from designations

applied by shareholders who are nonresident alien individuals?

FACTS

R, a domestic corporation, is registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.*, as a management company and has elected to be treated as a RIC under subchapter M, part 1, of the Code. Some of the shareholders of *R* are individuals who are United States persons, and some of the shareholders are nonresident alien individuals. For its first taxable year beginning after December 31, 2004, *R*'s taxable income consists of \$10,000*x* of dividend income (all of which is qualified dividend income within the meaning of § 1(h)(11)), \$10,000*x* of interest income (all of which is qualified interest income within the meaning of § 871(k)(1)), \$5,000*x* of net short-term capital gain, and \$5,000*x* of net long-term capital gain. *R* has general and administrative expenses of \$10,000*x*. *R* distributes \$20,000*x* to its shareholders for the taxable year, of which \$20*x* is received by shareholder *A*, an individual who is a United States person, and \$20*x* is received by shareholder *B*, a nonresident alien individual who does not have any effectively connected income as defined in § 864(c).

LAW AND ANALYSIS

Section 854, as amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "JGTRRA"), Pub. L. No. 108-27, 117 Stat. 752, and the Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, 118 Stat. 1166, provides rules for determining the amount distributed by a RIC to its shareholders that

may be treated by the shareholders as qualified dividend income under § 1(h)(11). Under § 1(h)(11), qualified dividend income received by an individual, estate, or trust is subject to a maximum tax rate of 15 percent. Section 854(b)(1)(C) provides that the aggregate amount that may be designated by a RIC as qualified dividend income for purposes of § 1(h)(11) generally shall not exceed the RIC's qualified dividend income for the taxable year. Section 854 does not require that this amount be reduced by expenses.

Section 871(k), as amended by the American Jobs Creation Act of 2004 (the "AJCA"), Pub. L. No. 108-357, 118 Stat. 1418, provides rules for determining the amount distributed by a RIC to its shareholders that may be treated by the shareholders as interest-related dividends or short-term capital gain dividends. Under § 871(k), an interest-related dividend or a short-term capital gain dividend received by a nonresident alien individual generally is not subject to United States withholding tax.

Section 871(k)(1)(C) limits the amount a RIC may designate as an interest-related dividend to the RIC's qualified net interest income for the taxable year. Section 871(k)(1)(D) defines qualified net interest income as a RIC's qualified interest income reduced by the deductions properly allocable to such income.

Section 871(k)(2)(C) limits the amount a RIC may designate as a short-term capital gain dividend to the RIC's qualified short-term gain for the taxable year. Section 871(k)(2)(D) defines qualified short-term gain as the excess of the RIC's net short-term capital gain for the year over the RIC's net long-term capital loss for such year, generally determined without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of such year. Section 1222(5) defines net short-term capital gain as the excess of short-term capital gains for the taxable year over short-term capital losses for such year. The Statement of Managers in the Conference Report accompanying the AJCA states, "In computing the amount of short-term capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC allocable to such net gains." 1 H.R. Rep. No. 548, 108th Cong., 2d Sess. 166 (2004).

Section 852(b)(3) provides rules for determining the amount distributed by a RIC to its shareholders that may be treated by the shareholders as a capital gain dividend. Section 852(b)(3)(C) limits the amount a RIC may designate as a capital gain dividend to the RIC's net capital gain for the taxable year, generally determined without regard to any net capital loss or net long-term capital loss attributable to transactions after October 31 of such year. Section 1222(11) defines net capital gain as the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.

For purposes of determining the taxable income of a RIC under subchapter M, § 852(b) separates a RIC's net capital gain from its other income (identified as "investment company taxable income"). Section 852(b)(3) imposes a tax on the excess of the RIC's net capital gain over its deduction for dividends paid determined with reference to capital gains dividends only. A RIC is not allowed any deduction for expenses against its net capital gain. A RIC's investment company taxable income equals its taxable income (exclusive of net capital gain) reduced by allowable expenses and its deduction for dividends paid determined without regard to capital gains dividends and exempt-interest dividends. Thus, the basic pattern for taxing a RIC's income treats its expenses as allocable only to its investment company taxable income (exclusive of net capital gain).

In this situation, under § 852(b)(3)(C), the maximum amount *R* may designate as capital gain dividends is $\$5,000x$, which is the amount of *R*'s net capital gain for the taxable year ($\$5,000x$ of net long-term capital gain less $\$0x$ of net short-term capital loss). Of the remaining distribution of $\$15,000x$ for the taxable year, *R* applies the rules of §§ 854 and 871 to determine the maximum amounts it may designate as qualified dividend income, short-term capital gain dividends, and interest-related dividends. Under § 854(b)(1)(C), the maximum amount *R* may designate as distributions of qualified dividend income is $\$10,000x$, which is the amount of *R*'s qualified dividend income for the taxable year, unreduced by expenses. Under § 871(k)(2)(C), the maximum amount *R* may designate as short-term capital gain dividends is $\$5,000x$, which is the amount of *R*'s net short-term capital gain unre-

duced by expenses allocable to that net gain. Under § 871(k)(1)(C), the maximum amount *R* may designate as interest-related dividends is $\$10,000x$ (the amount of *R*'s qualified interest income), less the amount of *R*'s expenses properly allocable to that income. Given the specific provisions of § 852(b)(3) precluding an allocation of expenses to reduce net capital gain, and taking into account the statement in the Conference Report that assumes that a portion of a RIC's expenses are allocable to its short-term gains, *R* may reasonably determine that its expenses should be allocated *pro rata* to the components of its income included in RIC taxable income (qualified dividends, interest, and short-term gains) and that the amount of its expenses properly allocable to interest income is $\$4,000x$. Accordingly, the maximum amount *R* may designate as interest-related dividends is $\$6,000x$.

The sum ($\$26,000x$) of the maximum amounts computed above of capital gain dividends ($\$5,000x$), distributions of qualified dividend income ($\$10,000x$), short-term capital gain dividends ($\$5,000x$), and interest-related dividends ($\$6,000x$), exceeds the total amount distributed by *R* for the taxable year ($\$20,000x$). If *R* uses these maximum amounts in making its dividend designations for the taxable year, the designations that are relevant for each of *A* and *B* will not exceed their respective dividend distributions. The reduced tax rate applicable to distributions of qualified dividend income, and thus the designation as such a distribution, apply to individual taxpayers who are United States persons and do not apply to income received by a nonresident alien individual unless the income is effectively connected with the conduct of a trade or business within the United States. In contrast, the exemption from United States withholding tax for interest-related dividends and short-term capital gain dividends received from a RIC applies only to dividends that are received by a nonresident alien individual and that are not effectively connected with the conduct of a trade or business within the United States.

There is no indication that Congress, in enacting the exemption from United States withholding tax in the AJCA for interest-related dividends and short-term capital gain dividends received from a RIC

by a nonresident alien individual, intended to reduce the benefits conferred by the JGTRRA for qualified dividend income received from the RIC by individuals who are United States persons. Similarly, there is no indication that Congress intended that the benefits conferred by the JGTRRA for qualified dividend income received from a RIC would apply to reduce the benefits conferred by the AJCA for interest-related dividends and short-term capital gains received from the RIC. To achieve the purposes of the provisions of both the AJCA and the JGTRRA, *R* may designate each of the maximum amounts described above, and *A* and *B* may apply different designations to their distributions.

Therefore, with respect to its dividend distributions of $\$20,000x$ for the taxable year, *R* may designate $\$5,000x$ as a capital gain dividend, $\$10,000x$ as a distribution of qualified dividend income, $\$6,000x$ as an interest related dividend, and $\$5,000x$ as a short-term capital gain dividend. These are, respectively, 25 percent, 50 percent, 30 percent, and 25 percent of the $\$20,000x$ distribution. If *R* makes these designations and properly advises its shareholders that these percentages apply to the distributions that each received, then *A* and *B* may apply the designations as follows. Of the $\$20x$ received by *A* from *R*, *A* may treat 25 percent ($\$5x$) as a capital gain dividend and 50 percent ($\$10x$) as qualified dividend income that is subject to a maximum tax rate of 15 percent. The remaining $\$5x$ is reportable as dividend income that is not qualified dividend income. Of the $\$20x$ received by *B* from *R*, *B* may treat 25 percent ($\$5x$) as a capital gain dividend, 30 percent ($\$6x$) as an interest-re-

lated dividend, and 25 percent ($\$5x$) as a short-term capital gain dividend. The remaining $\$4x$ is dividend income that is not qualified dividend income. Assuming all other necessary conditions are satisfied, the $\$5x$ of capital gain dividends, the $\$6x$ of interest-related dividends, and $\$5x$ of short-term capital gain dividends are exempt from United States withholding tax.

HOLDINGS

(1) In making the dividend designations permitted by §§ 852(b)(3)(C) and (b)(5)(A), 854(b)(1) and (2), and 871(k)(1)(C) and 2(C), a RIC may designate the maximum amount permitted under each provision even if the aggregate of all of the amounts so designated exceeds the total amount of the RIC's dividend distributions.

(2) Individual shareholders of the RIC who are United States persons may apply designations to the dividends they receive from the RIC that differ from designations applied by shareholders who are nonresident alien individuals.

DRAFTING INFORMATION

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