Part III—Administrative, Procedural, and Miscellaneous

Capital Gain Dividends of RICs and REITs

Notice 2004–39

SECTION 1. PURPOSE

This notice provides guidance to regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and their shareholders in applying § 1(h) of the Internal Revenue Code to capital gain dividends of RICs and REITs. The notice explains how the changes to § 1(h) made by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "JGTRRA"), Pub. L. No. 108–27, 117 Stat. 752, apply to RIC and REIT capital gain dividends paid (or accounted for as if paid) in taxable years that end on or after May 6, 2003.

SEC. 2. BACKGROUND

For individuals, estates, and trusts, § 1(h) imposes differing rates of tax on various transactions depending on the types of transactions giving rise to net capital gains. For transactions taken into account during taxable years ending before May 6, 2003, a taxpayer's long-term capital gains and losses generally are separated into three tax-rate groups: a 20–percent group, a 25–percent group, and a 28–percent group. See Notice 97–59, 1997–2 C.B. 309. For certain taxpayers, transactions in the 20–percent group may be taxed at a 10–percent rate, or at an 8–percent rate if the gain is qualified 5–year gain under § 1(h)(9) (as in effect before the enactment of the JGTRRA).

For transactions taken into account during taxable years ending on or after May 6, 2003, and beginning before January 1, 2009, the JGTRRA reduced the 20–percent rate to 15 percent, reduced the 10–percent rate to 5 percent (0 percent for taxable years beginning after 2007), and repealed the rules dealing with qualified 5–year gain. For a taxable year that includes May 6, 2003, the reduction in rates and the repeal of the rules dealing with qualified 5–year gain apply to gain or loss properly taken into account for the portion of the taxable year on or after May 6, 2003. Because this effective date generally occurs sometime during a taxpayer's taxable year, the amount of capital gain that benefits from the reduced 15–percent (or 5–percent) rate is generally the lesser of the net capital gain for the entire taxable year or the net capital gain determined using only gain and loss properly taken into account for the portion of the taxable year on or after May 6, 2003. JGTRRA § 301(c)(1)–(2) ("the JGTRRA transition rule"). In applying the JGTRRA transition rule with respect to a pass-through entity, the determination of when gains and losses are properly taken into account is made at the entity level. Id. § 301(c)(4). See the last paragraph of Section 3 of this notice for the application of this rule.

The Secretary has authority to issue regulations concerning the application of § 1(h) to sales and exchanges by (and of interests in) pass-through entities, including RICs and REITs. § 1(h)(9).

To the extent that a RIC or a REIT has net capital gain for a taxable year, it may designate as capital gain dividends the dividends that it pays during the year, the dividends that § 855 or 858 deems it to pay during the year, or deficiency dividends under § 860 that it pays for that year. In general, a capital gain dividend is treated by the shareholders that receive it as a gain from the sale or exchange of a capital asset held for more than one year.

Notice 97–64, 1997–2 C.B. 323, describes regulations that will be issued under § 1(h) concerning the application of § 1(h) to capital gain dividends of RICs and REITs, effective for taxable years ending on or after May 7, 1997. As described in Notice 97–64, the regulations will allow a RIC or REIT to make additional designations of capital gain dividends to reflect the differing tax-rate groups under § 1(h) and will provide limitations on the amounts that can be designated in the differing tax-rate groups. In calculating those limitations, the regulations will provide for a deferral adjustment or bifurcation adjustment in certain situations. In addition, the regulations will provide special rules for distributions of § 1202 gain.

Moreover, when those regulations are issued, they will reflect changes to § 1(h) since the publication of Notice 97–64. (For example, the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105–277, 112 Stat. 2681–886, ended the relevance of holding a capital asset for more than 18 months.)

This Notice 2004–XX describes how the reduction in rates made by the JGTRRA and the JGTRRA transition rule (for taxable years that include May 6, 2003), apply to capital gain dividends of RICs and REITs. Future guidance may be issued to clarify certain of the rules originally described in Notice 97–64 and to make other modifications to take into account industry experience with the rules. That guidance generally will apply on a prospective basis.

SEC. 3 APPLICATION OF § 1(h) TO RIC AND REIT CAPITAL GAIN DIVIDENDS

For taxable years ending on or after May 6, 2003, the rules described in Notice 97–64 continue to apply to capital gain dividends of RICs and REITs, with appropriate modifications to take into account the changes that have been made to § 1(h) since that notice was published. Thus, if a RIC or REIT designates a dividend as a capital gain dividend, the RIC or REIT may make an additional designation of the dividend as a 15%–rate gain distribution, subject to the limitations described in section 5 of Notice 97–64, including the limitation that the additional designation of a class of capital gain dividend not exceed the maximum distributable amount in that class.

In general, a RIC or REIT determines the maximum distributable amounts that may be designated in each class of capital gains dividends by performing the computation required by § 1(h) as if the RIC or REIT were an individual whose ordinary income is subject to a marginal tax rate of at least 28 percent. The maximum distributable gain in each class of capital gain dividends is equal to the amount that, in the computation under § 1(h), is multiplied by the corresponding rate gain percentage. The computation under § 1(h), however, is modified in the following ways:

- The RIC or REIT disregards qualified dividend income. That is, net capital gain is not increased by qualified dividend income, and qualified dividend income is disregarded in determining the amount of gain properly taken into account for the portion of a taxable year on or after May 6, 2003. (Under § 854(b) or § 857(c), qualified dividend income received by the RIC or REIT may contribute to a separate designation of other RIC or REIT dividends.)
- The RIC or REIT makes the deferral adjustment or bifurcation adjustment described in section 6 of Notice 97–64.
- The computation takes into account, if applicable, the JGTRRA transition rule for taxable years that contain May 6, 2003. The JGTRRA transition rule, however, interacts with the deferral adjustment in a way that differs from the interaction between that adjustment and the transition rule for the 1997 reductions in capital gains rates. That is, for purposes of the JGTRRA transition rule, the deferral adjustment is applied in determining whether a gain or loss is taken into account before May 6, 2003, or after May 5, 2003. For example, if a RIC sells shares of stock before May 6, 2003, but the sale is treated under § 852(b)(3)(C) and § 1.852–11(e) as arising after that date, the sale is taken into account on the later date for purposes of the JGTRRA transition rule. This application of the deferral adjustment differs from the special rule in section 6 of Notice 97–64 for transactions occurring during 1997.

The JGTRRA transition rule applies at both the RIC/REIT level and at the shareholder level. That is, the rule applies at the RIC/REIT level to taxable years of the RIC or REIT that contain May 6, 2003, to govern how capital gain dividends may be designated, and it applies to taxable years of RIC/REIT shareholders that contain May 6, 2003, to govern the application of § 1(h) to the shareholder for that taxable year. Thus, if a RIC or REIT pays a capital gain dividend during 2004 that it properly designates as a 20%–rate gain distribution and the dividend is received by a fiscal year trust in a year of the trust that includes May 6, 2003, the dividend is treated by the trust as gain that is properly taken into account for the portion of the taxable year before May 6, 2003. On the other hand, if that same capital gain dividend is received during 2004 by an individual shareholder, or a trust, whose taxable year is the calendar year, the dividend is subject to tax at a rate no higher than 15 percent, because the JGTRRA transition rule applies only to shareholder taxable years that include May 6, 2003.

In taxable years beginning on or after May 6, 2003, some taxpayers may receive a RIC or REIT distribution amount that is designated as a 20%–rate gain distribution and that includes a portion constituting 5–year gain. As a result of the repeal of the separate rules for 5-year gains, the 5–year gain portion of that 20%–rate gain distribution is not subject to the prior-law 8–percent rate for 5–year gain. These taxpayers, however, will not be disadvantaged by the rate changes. The 5–year gain portion will be treated the same as any other 20%–rate gain distribution that is received in a taxable year beginning on or after May 6, 2003, and therefore will be taxed at a rate no higher than 15 percent (5 percent for certain taxpayers). Any taxpayer that would have been eligible in a taxable year to pay tax at the 8–percent rate for some or all 5–year gain had the prior rates remained in effect will be eligible under the new rules to pay tax on that amount of 5–year gain at the 5–percent rate.

SEC. 4 EXAMPLES

(1) Example 1. RIC X's taxable year ends on April 30. X has only the following capital gains and losses for the periods indicated, all of which are from sales of stock held for less than five years:

	GAIN	**LOSS**	**NET**
5/1 to 5/5/2003			
Long-term capital gain or loss	100x	0	100x
Short-term capital gain or loss	100x	0	100x
5/6 to 10/31/2003			
Long-term capital gain or loss	0	0	0
Short-term capital gain or loss	0	(90x)	(90x)
11/1 to 4/30/2004			
Long-term capital gain or loss	110x	0	110x
Short-term capital gain or loss	0	0	0

X does not make a deferral adjustment because X does not have a post-October net capital loss or net long-term capital loss for its taxable year ending April 30, 2004. X must make a bifurcation adjustment, however, because it has a pre-November net capital gain, it has a taxable year ending in April, and it does not make a deferral adjustment. Because X must apply both the bifurcation adjustment and the JGTRRA transition rule, for the pre-November and post-October portions of this taxable year X must make separate determinations of the maximum amounts that may be designated as 20%–rate gain and 15%–rate gain. The sum of these amounts determines the various maximum amounts that can be designated in the different classes of gain for the entire year.

For the pre-November period, the JGTRRA transition rule applies because the period includes May 6, 2003. Thus, X determines a net capital gain amount using only gain and loss properly taken into account for the portion of the taxable year that is on or after May 6, 2003 (and, because the determination is for the pre-November period, on or before October 31, 2003). The amount so determined is $0. X's net capital gain for the entire pre-November period is $100x. Thus, for the pre-November period, X's maximum designation of 20%–rate gain is $100x and its maximum designation of 15%–rate gain is $0. (X also has a net short-term gain of $10x in the pre-November period, which results in a dividend that is not specially designated and is treated by shareholders as ordinary income.)

For the post-October period, the JGTRRA transition rule does not apply because that period does not include May 6, 2003. Because X has $110x of net capital gain for that period, X's maximum designation of 15%–rate gain is $110x.

For the taxable year ending April 30, 2004, therefore, X may designate up to $210x of capital gain dividends, of which up to $110x may be designated as 15%–rate gain distributions and up to $100x may be designated as 20%–rate gain distributions.

(2) Example 2. RIC Y's taxable year ends on April 30. Y has only the following capital gains and losses for the periods indicated, all of which are from sales of stock held for less than five years:

	GAIN	LOSS	NET
5/1 to 5/5/2003			
Long-term capital gain or loss	90x	0	90x
Short-term capital gain or loss	0	0	0
5/6 to 10/31/2003			
Long-term capital gain or loss	0	(90x)	(90x)
Short-term capital gain or loss	0	0	0
11/1 to 4/30/2004			
Long-term capital gain or loss	100x	0	100x
Short-term capital gain or loss	0	0	0

Y does not make a deferral adjustment because it does not have a post-October net capital loss or net long-term capital loss for its taxable year ending April 30, 2004. Y does not make a bifurcation adjustment because it does not have a net capital gain for the pre-November portion of its taxable year ending April 30, 2004. Because Y's taxable year ending April 30, 2004, includes May 6, 2003, the JGTRRA transition rule applies in determining Y's maximum designations of capital gain for that taxable year.

Y's net capital gain for the entire year is $100x. Y's net capital gain determined using only gain and loss properly taken into account for the portion of the taxable year on or after May 6, 2003, however, is $10x. For this taxable year, Y may designate up to $100x of capital gain dividends, of which up to $10x may be designated as 15%–rate gain distributions and up to $90x may be designated as 20%–rate gain distributions.

Assume that Y pays a capital gain dividend on December 1, 2004, and that, under § 855(a), Y treats the dividend as having been paid during its taxable year ending April 30, 2004, but that, under § 855(b), Y's shareholders treat the dividend as having been received in their taxable years that contain December 1, 2004. Assume also that shareholder A of Y is an individual, estate, or trust whose taxable year is the calendar year and that, on December 1, 2004, A receives from Y a dividend of $10x, of which $1x is designated as a 15%–rate gain distribution and $9x is designated as a 20%–rate gain distribution. Because A's 2004 taxable year does not include May 6, 2003, neither the JGTRRA transition rule nor JGTRRA § 301(c)(4) applies to A for that taxable year. Thus, the $10x capital gain dividend received by A in 2004 is subject to a tax rate no higher than 15 percent.

DRAFTING INFORMATION

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