

CAPITAL GAIN DISTRIBUTIONS OF REGULATED INVESTMENT COMPANIES

Notice 2015-41

SECTION 1. PURPOSE

This notice provides guidance to regulated investment companies (“RICs”) and their shareholders under §§ 1(h) and 852(b) of the Internal Revenue Code concerning capital gain dividends of RICs. Notice 97-64, 1997-2 C.B. 323, described regulations to be issued under § 1(h) for RICs and real estate investment trusts (“REITs”). Notice 2004-39, 2004-1 C.B. 982, provided related guidance on the effect of subsequent changes to § 1(h). This notice addresses how changes to § 852 made by the Regulated Investment Company Modernization Act of 2010 (the “RIC Modernization Act”), Pub. L. No. 111-325, 124 Stat. 3537, affect the bifurcation adjustment described in Notice 97-64 and other aspects of the computation of capital gain dividends of RICs.¹ This notice does not address REITs.

SECTION 2. BACKGROUND

For individuals, estates, and trusts, § 1(h) imposes differing rates of tax on net capital gains depending on the type of transaction in which the gains arise and on the

¹ Some relevant provisions of § 852 that were amended by the RIC Modernization Act were further amended by technical corrections in the Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, 128 Stat. 4010. The descriptions in this notice of the affected provisions generally treat the corrections as if they were made at the time of the enactment of the RIC Modernization Act.

taxable income of the taxpayer. The types of transaction in which a capital gain arises may cause the gain to fall into one of three rate groups: a 28-percent group (generally, gains from collectibles), a 25-percent group (generally, unrecaptured section 1250 gain), and a 20-percent group (most other net capital gain). Gains from transactions in the 20-percent group may be taxed at a 20-percent rate, a 15-percent rate, or a 0-percent rate, depending on the taxpayer's taxable income.² Certain gains from the sale or exchange of qualified small business stock held for more than five years are subject to a partial exclusion under § 1202(a) and a 28-percent rate on the non-excluded portion under § 1(h)(7).

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

Under § 852(b)(3), a RIC that has net capital gain for a taxable year may distribute capital gain dividends to its shareholders. A capital gain dividend is a dividend, or part thereof, that is properly reported as such by the RIC in written statements furnished to its shareholders. In general, a capital gain dividend paid by a RIC 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.

If a RIC's net capital gain for a taxable year exceeds its deduction for dividends paid determined with reference to capital gain dividends only, then the RIC is subject to tax as determined under § 1201(a) on that excess. See § 852(b)(3)(A). Under

² See § 1(h). The description of the rate groups reflects amendments to § 1(h) after the publication of Notice 97-64. These post-1997 amendments were contained in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "JGTRRA"), Pub. L. No. 108-27, 117 Stat. 752, and the American Taxpayer Relief Act of 2012 (the "ATRA"), Pub. L. No. 112-240, 123 Stat. 2313.

§ 852(b)(3)(D), the RIC may designate an amount of “undistributed capital gains” with respect to its shares. The RIC’s designation must be in a written notice mailed to the RIC’s shareholders prior to the expiration of 60 days after the close of the RIC’s taxable year. As a result of this designation, all of the following occur:

- Each shareholder of the RIC at the close of the RIC’s taxable year must include the shareholder’s designated amount in computing the shareholder’s long-term capital gain for the shareholder’s taxable year in which the RIC’s taxable year ends. The amount so includable, however, must not exceed the portion of the amount subjected to tax in the RIC’s hands that the shareholder would have received if, rather than subjecting amounts to tax under § 852(b)(3)(A), the RIC had distributed those amounts as capital gain dividends to its shareholders at the close of its taxable year.
- The shareholder is treated as having paid an amount of tax equal to the tax that the RIC was required to pay on the designated amount.
- The shareholder increases the basis of the relevant shares by the difference between the shareholder’s designated amount and the amount of tax that both was paid by the RIC and is deemed to have been paid by the shareholder.

If a RIC reports amounts as capital gain dividends to shareholders, the reports are ineffective to the extent that the aggregate amounts so reported exceed the RIC’s net capital gain for the taxable year.³ See § 852(b)(3)(C). If a RIC has two or more classes of stock and reports to one class a type of dividend that exceeds that class’s

³ The RIC’s net capital gain for a taxable year determines the amount of capital gain dividends that may be treated as distributed with respect to that taxable year. Thus, the RIC’s net capital gain for the taxable year affects not only dividends that are treated by shareholders as paid during the year but also dividends governed by either § 855 or § 860.

proportionate share of the corresponding type of income, then the report is ineffective for tax purposes to the extent that the reported amount exceeds that class's proportionate share. See Rev. Rul. 89-81, 1989-1 C.B. 226. This holding applies both to capital gain dividends and to designations of undistributed capital gains.

Prior to the amendment of § 852 by the RIC Modernization Act, in computing net capital gain for purposes of determining the maximum capital gain dividends for a taxable year, most RICs were required by § 852(b)(3)(C) to disregard any net capital loss or net long-term capital loss attributable to transactions after October 31 of the taxable year. Any such post-October net capital loss or net long-term capital loss was treated for those purposes as arising on the first day of the next taxable year. For purposes of determining a RIC's taxable income, however, § 1.852-11(f) of the Income Tax Regulations provided for elective deferral of any portion of the post-October net capital loss or net long-term capital loss.

Notice 97-64 describes rules under which a RIC may make additional designations of capital gain dividends and undistributed capital gains to reflect the various rate groups under § 1(h). That notice also establishes a bifurcation adjustment under which a RIC is required in certain circumstances to bifurcate its taxable year into a pre-November portion and a post-October portion for purposes of determining the appropriate additional designations of capital gain dividends that the RIC may make with respect to that taxable year. Gains and losses are netted separately for each portion of the taxable year. The purpose of the bifurcation adjustment is to prevent post-October losses from causing pre-November gains to be recharacterized as gains from another rate group after the RIC has--

- Taken the pre-November gains into account in a calculation of the required distribution described in § 4982(b);
- Made one or more late-December distributions to its shareholders that appeared necessary under that calculation to avoid excise tax under § 4982(a); and
- Made one or more reports to shareholders regarding those distributions reflecting the conclusions of the calculation.

Notice 2004-39 explains in part how changes to § 1(h) made by the JGTRRA apply to certain RIC capital gain dividends. Notice 2004-39 provides that the rules described in Notice 97-64 continue to apply to RIC capital gain dividends, subject to appropriate modifications to take into account later changes to § 1(h). The changes to § 1(h) made by the ATRA generally did not affect the conclusions in Notice 2004-39.

Sections 871(k)(2) and 881(e) allow a RIC to report as short-term capital gain dividends certain dividends paid to nonresident aliens and foreign corporations.⁴ Prior to the amendment of § 871(k)(2) by the RIC Modernization Act, a RIC was required to determine the amount of short-term capital gain dividends for a taxable year without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the year. Any such net capital loss or net short-term capital loss was treated as arising on the first day of the next taxable year.

Section 308 of the RIC Modernization Act made two significant changes affecting the deferral by a RIC of capital losses arising in the portion of a taxable year after October 31. First, it made the deferral of eligible losses elective for all purposes. Under

⁴ Under the current definition in § 871(k)(2)(C) (which applies for purposes of §§ 871(k)(2) and 881(e)), the term “short-term capital gain dividend” does not include a dividend with respect to a RIC’s taxable year beginning after December 31, 2014.

§ 852(b)(8)(A), a RIC may elect to defer any portion of its eligible losses, and that election applies for purposes of computing both the RIC's taxable income and the maximum amounts the RIC may distribute as capital gain dividends under § 852(b)(3)(C) and short-term capital gain dividends under §§ 871(k)(2)(C) and 881(e)(2). See § 852(b)(8)(A). Second, the RIC Modernization Act expanded the category of capital losses that may be deferred. A RIC's elective deferral applies to its "late year ordinary loss," which includes any "post-October capital loss." A post-October capital loss includes not only a net capital loss, or net long-term capital loss, attributable to the portion of the taxable year after October 31, but also a net short-term capital loss attributable to that portion of the taxable year. See § 852(b)(8)(C).

In describing this provision, the Staff of the Joint Committee on Taxation explained that the principles of § 1.852-11 are to apply to the elective deferral of a qualified late-year loss, which includes a post-October capital loss, subject to any subsequent change in the regulations. See Staff of Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11), March 2011, at 682 n.1913. Section 1.852-11(f) provides that, if a RIC elects to defer all or a portion of a post-October capital loss, its taxable income for the taxable year in which that loss arose is determined by including none of the capital gains or losses that were taken into account in computing the post-October capital loss, except for capital losses that equal in the aggregate the amount of the post-October capital loss that is not deferred. Any such non-deferred loss is treated as consisting first of any short-term capital losses to the extent thereof and then of any long-term capital losses taken into account in computing the post-October capital loss.

SECTION 3. REPORTING OR DESIGNATION OF RATE GROUPS

This notice modifies the reporting and designation rule described in section 3 of Notice 97-64 (which that notice called a “designation rule”) to require (rather than merely permit) a RIC that reports capital gain dividends or designates undistributed capital gains to indicate a rate group for its capital gain dividends or undistributed capital gains. This notice also modifies the reporting and designation rule to reflect both changes in capital gains rates under § 1(h) since Notice 97-64 was published and changes that the RIC Modernization Act made to the procedures for capital gain dividends under § 852(b).

If a RIC reports a dividend as a capital gain dividend for a taxable year in written statements furnished to its shareholders, as described in § 852(b)(3)(C), the RIC must also report in these statements the amounts of the dividend that constitute a “28% rate gain distribution,” an “unrecaptured section 1250 gain distribution,” a “section 1202 gain distribution,” and a “20% rate gain distribution.” Similarly, if a RIC designates an amount as undistributed capital gains for a taxable year in a written notice mailed to its shareholders, as described in § 852(b)(3)(D), the RIC must also designate in the written notice the amounts of the undistributed capital gains that the shareholders must include as a 28% rate gain distribution, an unrecaptured section 1250 gain distribution, a section 1202 gain distribution, or a 20% rate gain distribution.

The written statements or designations may be made in some circumstances on Internal Revenue Service forms. As of the date of this notice, Form 1099-DIV (dividends and distributions) and Form 2439 (undistributed capital gains) provide boxes corresponding both to total capital gain dividends (total long-term capital gain on Form 2439) and to all but one of the possible components of that total. That is, there are

boxes for unrecaptured section 1250 gain, for 28% rate gain, and for section 1202 gain, but not for 20% rate gain. If the written statements or designations described in this section 3 are made on Form 1099-DIV or Form 2439 (or successor forms that similarly provide boxes for reporting total capital gain dividends or total undistributed capital gain and for reporting all but one of the possible component types), then any amount of capital gain dividend or undistributed capital gain that is reported in the total and that is not reported in one of the component boxes is deemed to be reported or designated by the RIC as 20% rate gain (or whichever component type is missing from any such successor form). These deemed reports and designations are subject to the same limits as written reports and designations of rate groups. If the information on the forms is incomplete or incorrect, penalties may apply under § 6721 (failure to file correct information returns) and § 6722 (failure to furnish correct payee statements).

Reports (including deemed reports) and designations are ineffective for purposes of determining the rate group for a capital gain dividend or undistributed capital gains to the extent that the amounts reported or designated exceed the limits described in section 2 or section 5 of this notice. An amount that otherwise meets the requirements to be a capital gain dividend (or undistributed capital gain) does not fail to be a capital gain dividend (or undistributed capital gain) solely because of a failure by the RIC to make an effective report (or designation) of a rate group for the amount.

SECTION 4. SHAREHOLDER TREATMENT

Section 4 of Notice 97-64 continues to apply with appropriate modifications to take into account changes to § 1(h). Thus, a shareholder that receives a capital gain dividend from a RIC treats the dividend as follows:

- A 20% rate gain distribution is an amount of long-term capital gain in the 20-percent group (which may be taxed at a 20-percent rate, a 15-percent rate, or a 0-percent rate, depending on the shareholder's taxable income);
- An unrecaptured section 1250 gain distribution is an amount of long-term capital gain in the 25-percent group;
- A 28% rate gain distribution is an amount of long-term capital gain in the 28-percent group; and
- A section 1202 gain distribution generally is an amount of gain from a sale or exchange of qualified small business stock held for more than five years, subject to additional requirements and rules under § 1202(g).

SECTION 5. LIMITATIONS ON DESIGNATIONS OF CAPITAL GAIN DIVIDENDS

The limitations in section 5 of Notice 97-64 continue to apply, with appropriate modifications to take into account changes to § 1(h) and changes described in section 3 of this notice to the designation and reporting requirements.

Reports (or designations) of capital gain dividends (or undistributed capital gain) for a taxable year are effective only to the extent that the aggregate amounts reported or designated do not exceed applicable limitations.⁵ The additional reports and designations described in section 3 of this notice must be consistent with the principles of Revenue Ruling 89-81 and must not together exceed the following limits.

A RIC determines the maximum amount that may be reported or designated for each rate group by performing the computation required by § 1(h) (with the modifications

⁵ In addition to the limitations applicable to additional reports or designations (which are discussed in this section 5), the basic report or designation as a capital gain dividend or undistributed capital gain is limited by the maximum amounts set forth in § 852(b)(3)(C) and § 852(b)(3)(D), respectively.

described in this notice) as if the RIC were an individual whose ordinary income is subject to a marginal tax rate of 39.6 percent. In this determination--

- The maximum 20% rate gain is equal to the amount that is multiplied by 20% in the computation;
- The maximum unrecaptured section 1250 gain is equal to the amount that is multiplied by 25% in performing the computation; and
- The maximum 28% rate gain is the RIC's net capital gain for the taxable year minus the sum of the maximum unrecaptured section 1250 gain and the maximum 20% rate gain.

The computation under § 1(h) is modified in the following three ways:

- The RIC disregards qualified dividend income;
- The RIC must first give effect to any election under § 852(b)(8) to treat all or a portion of a post-October capital loss as arising on the first day of the next taxable year, as described in section 6 of this notice; and
- The RIC must give effect to the bifurcation adjustment described in section 7 of this notice, if applicable.

As described in section 8 of Notice 97-64, which continues to apply, the maximum distributable section 1202 gain for each issuer is calculated separately from the limitations on the other classes of capital gain dividends and may not in the aggregate exceed the RIC's net capital gain. Section 1202 gain distributions are subject to the limitations provided by § 1202(g).

SECTION 6. DEFERRAL UNDER § 852(b)(8)

The deferral adjustment described in section 6 of Notice 97-64 was a statutory requirement that section 308 of the RIC Modernization Act replaced with an elective deferral regime for taxable years beginning after December 22, 2010.

Under § 852(b)(8)(A), a RIC generally may elect to treat any portion of a qualified late-year loss for a taxable year as arising on the first day of the following taxable year for all purposes of the Code. Under § 852(b)(8)(B), a qualified late-year loss includes a post-October capital loss. Under § 852(b)(8)(C), a post-October capital loss means any net capital loss attributable to the portion of the taxable year after October 31, or if there is no such loss, any net long-term capital loss or net short-term capital loss attributable to that portion of the taxable year.

If a RIC elects under § 852(b)(8)(A) to treat all or a portion of its post-October capital loss as arising on the first day of the following taxable year, then for all purposes of the Code, all gains and losses taken into account in computing the post-October capital loss are treated as arising on the first day of the following taxable year, except for an amount of those losses (selected as described in the following paragraph) that equals in the aggregate the amount (if any) of the post-October capital loss that is not deferred. For example, if, for a taxable year, (i) a RIC has a post-October capital loss that is a net long-term capital loss attributable to the post-October portion of its taxable year and (ii) the RIC elects to defer all but \$5000 of that net long-term capital loss, then every one of the RIC's post-October long-term capital gains is treated as arising on the first day of the following taxable year, and every one of the RIC's post-October long-term capital losses is treated as arising on the first day of the following taxable year, except for long-term capital losses that in the aggregate equal \$5000.

If, for a taxable year, (i) a RIC has a post-October capital loss that is a net capital loss attributable to the post-October portion of its taxable year, and (ii) the RIC elects to defer less than the entire amount of that post-October capital loss, then as part of that election, the RIC determines the extent to which its long-term or short-term capital losses constitute the portion of the loss that is treated as arising in the taxable year (that is, the portion not deferred). If, for a taxable year, (i) a RIC has a post-October capital loss that includes long-term capital losses, and (ii) the RIC's election under § 852(b)(8)(A) (including the decision described in the preceding sentence) results in the deferral of less than all of those long-term capital losses, then as part of that election, the RIC determines the extent to which its losses from each rate group constitute the portion of the long-term capital loss that is treated as arising in the taxable year.

The deferral of a post-October capital loss under § 852(b)(8) does not extend the holding period associated with any of the gains or losses that, as a result of the deferral, are treated as arising on the first day of the following taxable year.

Pending further guidance, a RIC makes the election described in § 852(b)(8)(A) for a taxable year by giving effect to its elective deferral in computing its capital gains and losses for that taxable year and by completing its income tax return (including any necessary schedules) for the taxable year in accordance with the instructions for those items applicable to the election.

SECTION 7. BIFURCATION ADJUSTMENT

The bifurcation adjustment described in section 6 of Notice 97-64 continues to apply in certain circumstances. The criteria for the application of the bifurcation adjustment described below reflect that the RIC Modernization Act eliminated the mandatory

deferral adjustment, as described above in section 6, and broadened the scope of elective deferral under § 852(b)(8), as described above in section 2.

Unless a RIC is excepted from the requirements of § 4982 for the taxable year under § 4982(f), the RIC must make the bifurcation adjustment described below for a taxable year if--

- (1) The taxable year of the RIC is not the period used to determine capital gain net income for purposes of the excise tax imposed by § 4982;⁶
- (2) For the pre-November portion of the taxable year, the RIC has a net capital gain;
- (3) For the post-October portion of the taxable year, the RIC has a net loss in one or more rate groups that would cause pre-November net capital gain to be recharacterized (because the RIC would have less capital gain in a rate group for its full taxable year than for the pre-November portion of that year); and
- (4) The RIC does not have a post-October capital loss the deferral of which, in whole or in part, under § 852(b)(8)(A), would prevent recharacterization of the RIC's pre-November gain.

If a RIC is required to make a bifurcation adjustment, then, for all federal tax purposes, it must net its capital gains and losses as if the pre-November and post-October portions of its taxable year were separate taxable periods. The RIC must calculate its maximum distributable gain in each rate group separately for the pre-November and post-October portions of its year. The maximum distributable gain in

⁶ A RIC's taxable year coincides with the period for determining capital gain net income for purposes of the excise tax if either: (i) the RIC's taxable year ends with the month of October, or (ii) the RIC's taxable year ends with the month of November or December and the RIC has made the election under § 4982(e)(4).

each rate group for the taxable year is the sum of the maximum distributable amounts determined for the two portions of the year.

SECTION 8. EXAMPLE

The following example illustrates the application of section 7 of this notice:

RIC X's taxable year ends on July 31. X has only the following capital gains and losses for the periods indicated:

| 8/1/2015 to 10/31/2015 | Net gain / (loss) |
|-----------------------------------|--------------------------|
| Long-term capital gain or loss | |
| 20-percent group | \$100 |
| 25-percent group | |
| 28-percent group | |
| Short-term capital gain or loss | |
| 11/1/2015 to 7/31/2016 | |
| Long-term capital gain or loss | |
| 20-percent group | (\$100) |
| 25-percent group | |
| 28-percent group | \$150 |
| Short-term capital gain or loss | (\$50) |

For the post-October portion of its taxable year, X has a net short-term capital loss of \$50 and no net capital loss or net long-term capital loss. Therefore, under § 852(b)(8)(C), X has a post-October capital loss, which is the \$50 net short-term capital loss. Under § 852(b)(8)(A), X may elect to treat any portion of that loss as arising on the first day of the following taxable year for federal income tax purposes.

X has a taxable year that is not the period used to determine its capital gain net income for purposes of § 4982. X has net capital gain for the portion of its taxable year before November 1 (all of which is in the 20-percent group). X also has a loss in the 20-percent group for the portion of its taxable year after October 31. But for the bifurcation

adjustment, that post-October loss would cause recharacterization of pre-November gain because that post-October loss would cause X to have more gain in the 20-percent group for the pre-November portion of its taxable year (\$100) than for its full taxable year (\$0). More specifically, if X's gains and losses were netted for X's full taxable year, X's \$100 of gain in the 20-percent group for the pre-November portion of the year would be offset by the \$100 loss in the 20-percent group, with only gain in the 28-percent group remaining. X does not have a post-October capital loss the deferral of which would prevent such recharacterization, because whether or not X elects to defer its post-October capital loss (the \$50 short-term loss), the loss in the 20-percent group for the post-October portion would offset the gain in that rate group for the pre-November portion. Therefore, regardless of whether X elects to defer any portion of its post-October capital loss, X must make a bifurcation adjustment.

For the pre-November portion of its taxable year, X has \$100 of net capital gain all of which is in the 20-percent group. For the post-October portion, if X elects to defer its entire post-October capital loss, X has \$50 of net capital gain, all of which is in the 28-percent group. Because X's taxable year is bifurcated, the \$100 of loss in the 20-percent group in the post-October portion is netted with \$100 of the \$150 of gain in the 28-percent group in the post-October portion, and not with the \$100 of gain in the 20-percent group in the pre-November portion. Therefore, X may report (or designate) up to \$150 as capital gain dividends (or undistributed capital gains) with respect to its taxable year ending on July 31, 2016. If X reports the entire amount as capital gain dividends, X must report \$100 as 20% rate gain distributions and \$50 as 28% rate gain distributions. Because X elected to defer its entire post-October capital loss, X must

treat the short-term capital gains and losses constituting the \$50 post-October short-term capital loss as arising on August 1, 2016 (the first day of the next taxable year).

SECTION 9. CAPITAL LOSS CARRYOVERS

Because post-October losses are subject to deferral, a RIC's capital gain or loss computation for a taxable year may depend in part on whether a capital loss carryover from a prior year is treated as arising on the first day of the taxable year or ratably over the taxable year. Section 101 of the RIC Modernization Act changed the treatment of capital loss carryovers of RICs for years beginning after the date of its enactment (December 22, 2010) in several ways. Under § 1212(a)(3), capital loss carryovers are now treated as losses arising on the first day of the taxable year to which they are carried over.

Capital loss carryovers arising before the date of enactment of the RIC Modernization Act will likewise be treated as arising on the first day of the taxable year to which they are carried over and not as arising ratably during the year.

SECTION 10. EFFECT ON OTHER DOCUMENTS

Notice 97-64 and Notice 2004-39 are modified.

SECTION 11. EFFECTIVE DATE

This notice is effective for taxable years beginning after May 31, 2015. Taxpayers may rely on section 9 of this notice for prior taxable years. Taxpayers may rely on the other provisions of this notice for prior taxable years beginning after the date of enactment of the RIC Modernization Act (December 22, 2010).

SECTION 12. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of

1995 (44 U.S.C. 3507(d)) through the Forms 2439 (1545-0145) and 1099-DIV (1545-0110).

The collection of information in this notice is in section 3. This information is a minor modification to an existing requirement that applies to a RIC when providing written statements to its shareholders as described in § 852(b)(3)(C) and written notices to its shareholders as described in § 852(b)(3)(D). The likely respondents are RICs.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

SECTION 13. DRAFTING INFORMATION

The principal author of this notice is Steven Harrison of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this notice contact Steven Harrison at (202) 317-6842 (not a toll-free call).