

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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date: July 12, 2016

to: Eugene Chen, Actuary

from: Michele J. Gormley
Senior Counsel (Boston, Group 1)
(Large Business & International)

subject:

This memorandum is in response to your request for advice

We have
coordinated our advice herein with SME Valerie Hallman of the RNB IPG and Diane Helfgott,
Life Insurance Industry Counsel.

Background:

Facts:

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¹ See Statement of Statutory Accounting Principles “SSAP” No. 56, ¶3.

Issues:

You have asked for advice on the following issues:

Short-term Capital Gains and Taxation of Regulated Investment Companies

I.R.C. § 852(b)(1) imposes a normal tax and surtax, computed at the rates and in the manner prescribed in I.R.C. § 11, on investment company taxable income, as defined in I.R.C. § 852(b)(2), for each taxable year of a RIC. The tax is imposed as if investment company taxable income were the taxable income referred to in I.R.C. § 11.

In determining investment company taxable income, net capital gain income is excluded from taxable income of the RIC. I.R.C. § 852(b)(2)(A). The term net capital gain means the excess of the net long-term gain for the taxable year over the net short-term capital loss for the year. I.R.C. § 1222(11) Net long-term capital gains are excluded from investment company taxable income and net short term capital gains are included in investment company taxable income.

A net short-term capital gain loses its separate character as a short-term capital gain upon inclusion in investment company taxable income. A net short-term capital gain is treated as an ordinary income item for purposes of determining dividend distributions defined in I.R.C §

316 and the ordinary dividends paid deduction that is referenced in I.R.C. § 852(b)(2)(D) and defined in I.R.C. § 561.

The definitions of net capital gain, net short-term capital gain, and investment company taxable income are contained in and transform the definition of short-term capital gains. Short-term capital gains become ordinary income when short-term capital gains exceed short-term capital losses for the taxable year. Short-term capital gains become net capital gain when net long term gain exceeds the net short-term capital loss for the taxable year.

Short-term Capital Gains and Taxation of RIC Shareholders

A RIC's short-term capital gain attribute is relevant for purposes of RIC shareholder taxation in two instances:

- Where the RIC shareholder is a foreign person; and,
- To determine the portion of the ordinary dividend distribution of the RIC that may be eligible for the dividends received deduction.

RIC Shareholders - Exemption from Withholding Tax

A RIC is required to report short-term capital gain dividends to enable shareholders who are non-resident alien individuals or foreign corporations subject to withholding tax to avail themselves of a special exemption from withholding. I.R.C. §§ 871(k)(2)(C) and 881(e)(2). A short-term capital gain dividend is defined solely for this purpose in I.R.C. § 871(k)(2)(C). A short-term capital gain dividend is not a domestic shareholder tax attribute.

Corporate RIC Shareholders - Determination of the Dividends Received Deduction from Dividends Distributed by a RIC

A dividend received from a RIC is subject to the limitations in I.R.C. § 854. See I.R.C. § 243(d)(2). These limitations apply to the shareholder's tax treatment and not the RIC's. The burden of proper reporting is on the RIC shareholders, regardless of whether the amounts reported by the RIC are correct or incorrect.

A capital gain dividend received from a RIC is not considered a dividend for purposes of I.R.C. § 243, the dividends received deduction (DRD). See I.R.C. § 854(a).

I.R.C. § 854(b) provides that a corporate RIC shareholder may take into account in computing any deduction under I.R.C. § 243 only that portion of the dividend (other than a capital gain dividend) received from the RIC that is reported by the RIC as a dividend for purposes of I.R.C. § 243. Moreover, under I.R.C. § 854(b) an amount shall be treated as a dividend eligible for the dividends received deduction, only if a deduction would have been allowable under I.R.C. § 243 to the RIC determined as if I.R.C. § 243 applied to dividends received by a RIC, after the application of I.R.C. § 246 (but without regard to subsection (b) thereof), and, after the application of I.R.C. § 246A. See I.R.C. § 854(b)(3).

The source of DRD eligible dividend distributions to a corporate RIC shareholder must be dividend income received by the RIC that would be deductible by the RIC if it were taxed as a regular corporation. A short-term gain recognized by a RIC is not a DRD eligible dividend in the hands of the RIC.

DRD eligible dividend distributions that meet the § 854 limitations are deductible by the corporate RIC shareholder provided that the shareholder separately satisfies the general requirements for the dividends received deduction with respect to its RIC shares. See Revenue Ruling 91-68.

In making the dividend designations² permitted by §§ 852(b)(3)(C) and (b)(5)(A), 854(b)(1) and (2)³, 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. Here the RICs are allocating more than the total amount of the RIC's dividend distributions by allocating the expenses of the RIC differently for purposes of determining the maximum amount permitted under each provision. As a result, 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. See Revenue Ruling 2005-31

To prevent a life insurance company from obtaining a double benefit for tax preferred investment income⁴ used to fund deductible increases in the company's liabilities to policyholders, §§ 807 and 805 require the company to adjust certain income and deduction terms for the "policyholders' share" of the tax-preferred income.

I.R.C § 805(a)(4) permits a life insurance company to deduct only the life insurance company's share of inter-corporate dividends received (other than dividends from wholly owned subsidiaries). No DRD is allowed with respect to the policyholders' share of inter-corporate dividends.

I.R.C § 812 provides the mechanism to calculate the life insurance company's and the policyholders' share of the tax-preferred income items. I.R.C. § 812(a)(1) defines the company's share as the percentage obtained by dividing (i) the company's share of net investment income for the taxable year, by (ii) the net investment income for the taxable year. The policyholders' share is derived by subtracting the company's share from 100%.

² With the enactment of the Regulated Investment Company Modernization Act of 2010, (P.L. 111-325), the term "designated" was replaced with the term "reported" for tax years beginning after December 22, 2010.

³ § 854(b)(2) was re-designated § 854(b)(1)(B) by the Regulated Investment Company Modernization Act of 2010, (P.L. 111-325) for tax years beginning after December 22, 2010.

⁴ Examples are tax-exempt interest and inter-corporate dividends eligible for a DRD.



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Please do not hesitate to contact the undersigned at (617) 788-0799 if we can be of further assistance.

Sincerely,

MARVIS A. KNOSPE
Associate Area Counsel
(Large Business & International)

By: _____
Michele J. Gormley
Senior Counsel (Boston, Group 1)
(Large Business & International)