The Tax Authority for Accurate Basis Tracking

CCH Capital Changes In-Depth™

May 31, 2005
Volume 2 Issue 4

THE BEST OF BOTH WORLDS

New Mutual Fund Dividend Designation Tax Rules Benefit Foreign Investors Without Conflicting with Rules for U.S. Investors: IRS issues Favorable Rev. Rul. 2005-31

Under the American Jobs Creation Act of 2004 (the 2004 Tax Act), enacted into law on October 22nd, 2004, certain mutual fund dividends relating to eligible interest income and short-term capital gains can be designated and qualify as exempt from U.S. withholding tax for distributions paid to foreign investors. Mutual fund tax advisors were concerned that these new designation rules for dividends paid to foreign investors might potentially conflict with qualified dividend income designation of mutual fund dividends relevant to U.S. investors. Qualified dividend income designation is significant to U.S. individual investors because such dividends are generally eligible for taxation at lower long-term capital gain maximum tax rates. In order to address this potential conflict, on May 4th, 2005, the IRS released Revenue Ruling 2005-31 setting forth guidelines for determining the maximum amount of dividends paid by a mutual fund that can be designated as qualified interest income (QII), short-term capital gain dividends, and qualified dividend income (QDI).

Background

Mutual funds typically qualify for and elect special tax rules for regulated investment companies (RICs). Although RICs are generally taxed as corporations for U.S. income tax purposes, they receive a deduction for dividends paid to their shareholders if certain requirements are met.

Because a RIC is generally taxed as a corporation, distributions by a RIC to its shareholders are generally treated as dividends to the extent of the RIC's current and accumulated earnings and profits. Under U.S. tax law, corporate dividends do not generally retain the character of the income earned by the corporation. Thus, in the absence of special rules applicable to RICs, distributions by a corporation to its shareholders of tax-exempt bond income, short-term and long-term capital gains or interest income (which are all included in the corporation's earnings and profits) are simply treated as ordinary dividend income by a shareholder.

In order for RIC shareholders to obtain the same exclusion for tax-exempt bond interest and qualify for lower tax rates applicable to long-term capital gains from investments in RICs as if they had invested directly in such assets, the RIC rules generally provide that RIC dividends relating to tax-exempt income or net long-term capital gains recognized by the RIC are classified as "exempt interest dividends" or "capital gains dividends" in the hands of shareholders if the RIC meets certain requirements under Code Sec. 852.

Prior to the enactment of the 2004 Tax Act, there were no special dividend character rules for either U.S. or foreign shareholders relating to mutual fund interest earnings or short-term capital gains. Accordingly, distributions of such earnings and gains to shareholders were simply treated as ordinary dividend income. Unfortunately, ordinary dividends distributed by a U.S. RIC to non-U.S. shareholders were subject to U.S. withholding tax (at

a 30% rate unless reduced by tax treaties). Contrast this adverse treatment with the fact that distributions of interest earnings and short-term capital gains recognized directly by a non-U.S. shareholder are not generally subject to U.S. withholding tax (provided certain requirements are met). As a result, RICs have not generally been attractive investments for non-U.S. persons.

Mutual Fund Qualified Dividend Income Dividends & The Gross Limit on Designation

In 2003, the Jobs and Growth Tax Relief Reconciliation Act (the 2003 Tax Act) enacted special rules under Code Sec. 1(h)(11) for QDI. These rules provide that QDI for individual taxpayers is taxed at a maximum long-term capital gains rate of 15%. The RIC rules were amended to include Code Sec. 854(b)(1)(C) permitting RICs to designate a portion of RIC dividends paid to their investors as QDI (detailed discussion of these designation rules is intentionally omitted).

A key aspect of the RIC QDI designation rules relates to the defined limit set forth in Code Sec. 854(b)(1)(C) on the amount of RIC dividends that can be properly designated as QDI. The limit is a "gross" limit. Under this definition, the maximum amount does not take into account any deductible expenses incurred by the RIC. However, the maximum amount cannot generally exceed the amount of taxable dividends paid.

Example

Assume that a RIC earned the following amounts of income during its tax year: $300 of QDI dividends, $200 of taxable interest income eligible for U.S. withholding tax exemption (if investments had been owned directly by a foreign investor), $100 of short-term capital gains and $250 of long-term capital gains. Assume that the RIC incurred $200 of deductible expenses. For the tax year, the RIC distributes $650 to its shareholders ($300 plus $200 plus $100 plus $250 less $200). The fund designates $250 of the dividends paid as capital gain dividends taxable as long-term capital gains. The remaining $400 of dividends is taxable as ordinary income. Of course, to the extent a portion of the remaining $400 of ordinary dividends is treated as QDI, the lower 15% maximum tax rate would apply thereto.

What is the maximum amount of dividends that can be designated by the fund as QDI? The answer is $300 of the $400 of ordinary dividends can be designated QDI. This is because none of the expenses must be allocated to reduce the $300 of dividends that can be designated as QDI. Intuitively, because there has been no allocation of expenses against QDI, the $200 of expenses offset all but $100 of the non-QDI interest income.

2004 Tax Act Changes

The 2004 Tax Act adds new Code Sections 871(k) and 881(e) that exempt "interest-related dividends" (qualified interest income or QII) paid and properly designated by RICs from U.S. withholding tax when paid to non-U.S. shareholders. The Act also added Code Sections 871(k)(2) and 881(e)(2) providing a comparable U.S. withholding tax exemption for "short-term capital gain dividends" paid by RICs to nonresident alien individuals and foreign corporations. These provisions are effective with respect to dividends relating to tax years of RICs beginning after December 31, 2004. Note that the 2004 Tax Act provides that both of these provisions will be phased out and unavailable with respect to any RIC tax year beginning after December 31, 2007. Shareholders and RICs may lobby to push back or eliminate these phase-outs.

Both QII and short-term capital gain dividends cannot exceed specified maximums determined by the manner in which the Code defines these terms. The maximum amount of QII is reduced by properly allocable expenses under the definition set forth in Code Sec. 871(k)(1)(D). Short term capital gain dividends are defined as the excess of the net short-term

CAPITAL CHANGES IN-DEPTH™

Managing Editor
Denise Davidson, J.D.
847 267 2931
denise_davidson@cch.com

Senior Tax and Articles Editor
Stevie D. Conlon, J.D., C.P.A.
847 267 2428
stevie_conlon@cch.com

Designer
Don Torres

CCH Capital Changes has been providing continuous coverage of corporate actions affecting publicly traded companies since 1928, with a historical database that spans over 100 years. Today, CCH Capital Changes offers daily, weekly, and monthly reporting on U.S. and foreign issuers, in a variety of formats, including Internet, Lotus Notes®, and Direct Data Feed.

CCH welcomes articles submitted by outside authors for possible publication in Capital Changes In-Depth™. Manuscripts and inquiries should be directed to Denise Davidson or Stevie Conlon, **CCH** INCORPORATED, A WoltersKluwer Company, 2700 Lake Cook Rd, Riverwoods, IL 60015.

If you would like to receive a copy via email, please send a request to john_kareken@cch.com or stevie_conlon@cch.com.

capital gain of the RIC for the taxable year over the net long-term capital loss (if any) of such company for the tax year. Note that the definition of short-term capital gain dividends does not include any provision requiring that the amount be reduced for allocable expenses.

The interest-related dividend exemption for QII is not available for a shareholder (1) that is a controlled foreign corporation (CFC), but only to the extent the dividend is attributable to interest on debt of a person related to the CFC, (2) with respect to dividends attributable to interest (other than short-term original issue discount or bank deposit interest) on debt issued by the recipient shareholder or an entity in which the recipient is a ten percent shareholder (as defined by the Code), (3) that does not provide the withholding agent with beneficial owner certification similar to existing rules for portfolio interest or (4) in a foreign country if the IRS has determined such country provides inadequate exchange of information rules to prevent evasion of tax.

The short-term capital gains dividend exemption is not available in the case of a nonresident alien shareholder that is present in the U.S. for 183 days or more during the calendar year. However, the RIC is only obligated to withhold on short-term capital gains dividends paid to a nonresident alien shareholder if it knows that the recipient has been in the U.S. for 183 days or more during the calendar year.

Short-term capital gains eligible for the exemption are based on the net of (1) the RIC's short-term capital gains for the tax year, including short-term capital gains dividends from another RIC, over (2) net long-term capital losses (if any). For this purpose, net capital losses or net short-term capital losses attributable to transactions occurring after October 31 of the tax year are ignored (such transactions are treated as occurring on the first day of the next tax year.

Complexity and Concerns Regarding Designation

Because of the favorable U.S. withholding tax treatment for foreign investors receiving mutual fund dividends designated as QII, a key issue was the conceptual inconsistency between the determination of the maximum amount of dividends that could be designated as QII and the maximum amount of dividends designated as QDI. This issue arose because of the intuitive allocation of 100% of expenses to interest and income other than QDI dividends received in determining the maximum amount of QDI that a fund could designate. Thus, mutual funds and their advisors were worried that a method that maximized the amount of QDI designated would minimize the amount of QII designated, favoring U.S. individual shareholders over foreign shareholders, or vice versa.

Consider the example discussed earlier. $400 of taxable ordinary dividends were paid ($250 of long-term capital gains dividends were also paid). What is the amount that can be designated as QII? What is the amount that can be designated as short-term capital gain dividends? The mutual fund must first allocate a portion of its expenses against the $200 of eligible interest income. Assume the allocable amount of expenses is $67. If so, the maximum amount of QII that could be designated would be $133. What is the amount of dividends that can be designated as short-term capital gain dividends? Can the full $100 be designated (because there is no long-term capital loss for the year and expenses do not reduce the amount that can be designated)? The mutual fund has already designated $300 of the $400 of taxable ordinary dividends as QDI. Can the fund designate $133 as QII and $100 as short-term capital gain dividends? Note that the sum of these three designations exceeds the total amount of dividends paid ($300 QDI plus $133 QII plus $100 of short-term capital gain dividends exceeds $400 of total ordinary dividends).

Mutual funds and their advisors hoped that the IRS would focus on the technical wording of the defined maximums for QDI, QII and short-term capital gain dividends designations under the Code, which seemed to clearly operate independently of one another. They believed that focus on these precise definitions could permit a sort of "best of both worlds" outcome whereby the maximum amount of QDI, QII and short-term capital gain dividends designated would not need to be reconciled with each other. The Investment Company Institute wrote to the Treasury regarding their concerns in November, 2004.

Because the designation rules for mutual fund dividends paid to foreign investors under the 2004 Tax Act was effective for tax years of RICs beginning after December 31, 2004, mutual fund investors needed to understand the potential tax treatment effective as early as January 1, 2005. Thus, mutual funds needed guidance on this issue as soon as possible.

Revenue Ruling 2005-31

Revenue Ruling 2005-31 favorably addresses the maximum limits on the various designations of mutual fund dividends as QDI, QII and short-term capital gain dividends, while acknowledging the inconsistencies.

The ruling affirms that the maximum amount of QDI and short-term capital gain dividends that can be designated are not reduced by expenses. The ruling also clarifies the permitted methodology for determining the allocable share of expenses that must be subtracted in computing QII. For this purpose, Rev. Rul. 2005-31 provides that a RIC's expenses "…should be allocated pro rata to the components of its income included in RIC taxable income (qualified dividends, interest, and short-term gains)…" Note that long-term capital gains are not taken into account in computing the allocation of expenses.

The holdings of Rev. Rul. 2005-31 explicitly permit aggregate designations of QDI, QII and short-term capital gain dividends that exceed the total amount of a RIC's dividend distributions for the tax year and provide that RIC shareholders who are U.S. persons may apply designations to the dividends received that differ from the designations applied by non-U.S. shareholders.

Application of Rev. Rul. 2005-31 to Example

What is the impact of Rev. Rul. 2005-31 on the example set forth above? First, the ruling supports the designation of $300 of dividends as QDI. Second, the ruling permits the designation of $100 of the ordinary dividends as short-term capital gain dividends (because it is not necessary to reduce the amount eligible for designation by expenses). And, the permitted amount eligible for designation as QII can be determined because the ruling specifies a method for computing allocable expenses that must be subtracted from the RIC's eligible interest income. A fraction is computed based on the amount of eligible interest income ($200) divided by the total amount of RIC taxable income (excluding long-term capital gains)($300 plus $200 plus $100). The total expense amount of $200 is then multiplied by the fraction of 1/3. Thus, allocable expenses of $67 (rounded) must be subtracted from total eligible interest income of $200. Accordingly, $133 of ordinary dividends can be designated as QII.

And, as noted in Rev. Rul. 2005-31, these designations are appropriate even thought the total amount designated ($300 plus $100 plus $133) exceeds total ordinary dividends of $400.

Conclusion

Rev. Rul. 2005-31 validates a "best of both worlds" approach towards designating mutual funds dividends for favorable QDI U.S. shareholder treatment, as well as favorable QII and short-term capital gain dividend treatment for non-U.S. shareholders.

CCH Contact—Stevie Conlon 847 267-2428