

IRS issues Notice 2015-41: Reporting of Capital Gain Dividends, Post-October Loss Deferral and Bifurcation

The Internal Revenue Service (IRS) recently issued Notice 2015-41¹ (the “Notice”) which provides guidance to regulated investment companies (RICs) and their shareholders concerning capital gain dividends of RICs. This Notice also addresses how changes to IRC Section 852 by the RIC Modernization Act of 2010 (the “Act”) affect the bifurcation adjustment described in Notice 97-64² and other aspects of the computation of capital gains dividends of RICs. This notice is effective for taxable years beginning after May 31, 2015.

Background

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 Section 1(h). That notice also establishes a bifurcation adjustment where 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 gains dividends that the RIC may make with respect to that taxable year.

The Act changed the way a RIC could defer its capital losses arising in the portion of a taxable year after October 31 by making the deferral of eligible losses elective for all purposes³ and expanding the category of capital losses that may be deferred which applied to its late year ordinary losses which include any post-October capital loss⁴.

Reporting requirement for a RIC to specify rate gain group by category

The Notice makes changes to the designation rule included in Notice 97-64. It now requires (rather than permits) 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. The Notice also reflects changes in capital gains rates under Section 1(h) since Notice 97-64 was originally released and reflects changes made by the Act to the procedures for reporting capital gain dividends under Section 852(b).

¹ 2015-24 I.R.B. 1.

² 1997-2 C.B. 323.

³ IRC Section 852(b)(8)(A)

⁴ IRC Section 852(b)(8)(C)

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Under Section 852(b)(3)(C) a RIC reports a dividend as a capital gain dividend in written statements to its shareholders. It must also report the amount of the dividend that constitute the 28% rate gain distribution, an unrecaptured Section 1250 gain distribution, a Section 1202 gain distribution, and a 20% rate gain distribution. A RIC must do the same in any written designations of undistributed capital gains, as required by Section 852(b)(3)(D).

IRS Forms 1099-DIV (dividends and distributions) and Form 2439 (undistributed capital gains) may be used to satisfy the reporting and designation requirements. Those forms currently provide boxes for unrecaptured Section 1250 gain, 28% rate gain, and Section 1202 gain, but not for 20% rate gain. Any amount of capital gain dividends or undistributed capital gain that is reported in the total on these forms and that is not reported in one of these specific boxes will be deemed to be reported or designated by the RIC as 20% rate gain⁵.

Qualified late-year loss deferrals

The Notice provides that if a RIC elects under Section 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 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. This does not include the amount of those losses that equals in the aggregate the amount, if any, of the post-October capital loss that is not deferred. The deferral of a post-October capital loss does not extend the holding period associated with any of the gains or losses that are treated as arising on the first day of the following taxable year.

Bifurcation Adjustment and Capital Loss Carryovers

The IRS refined the scope of the elective deferral under Section 852(b)(8). The IRS also made it clear that where a RIC is exempt from the excise tax rules under Section 4982 the bifurcation rules do not apply. A RIC must make the bifurcation adjustment if: 1) the taxable year of the RIC is not the period used to determine the capital gain net income for purposes of the excise tax under Section 4982; 2) the RIC has a net capital gain for the pre-November portion of the taxable year; 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 that it can defer to prevent, in whole or in part, recharacterization of the RIC's pre-November gain.

If a RIC is required to make a bifurcation adjustment then bifurcation would also apply for calculating taxable income.

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. The Notice clarifies that capital loss carryovers arising before the date of enactment of the Act also will be treated as arising on the first day of the taxable year to which they are carried over.

⁵ The deemed reports and designations on IRS forms are subject to the penalties under IRC Sections 6721 (failure to file correct information returns) and 6722 (failure to furnish correct payee statements) if the information is incomplete or incorrect.

A RIC's 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 applicable limits to which such distributions or undistributed capital gains are subject.

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