

**MEMO# 33022**

January 6, 2021

# IRS Finalizes Regulations Permitting Section 163(j) Interest Dividends

[33022]

January 6, 2021 TO: ICI Members

Tax Committee SUBJECTS: Tax RE: IRS Finalizes Regulations Permitting Section 163(j) Interest Dividends

The Treasury Department and the Internal Revenue Service (IRS) have finalized [regulations](#) that permit regulated investment companies (RICs) to pass through interest income to corporate shareholders for purposes of determining such corporations' interest expense limitation under section 163(j), as requested by ICI.[\[1\]](#) The final regulations provide a RIC's corporate shareholders with interest income rather than ordinary dividend income, potentially increasing the amount of interest expense the shareholders can deduct under the new limits implemented by the 2017 tax legislation commonly referred to as the "Tax Cuts and Jobs Act." The final regulations adopt proposed regulations, with no significant changes, released last year.[\[2\]](#)

## Section 163(j) Interest Dividends

A section 163(j) interest dividend is defined in the final regulations as any dividend, or part of a dividend, that is reported by the RIC as a section 163(j) interest dividend in written statements provided to its shareholders. The amount of section 163(j) interest dividends that a RIC may report is limited to the excess of the RIC's business interest income for the taxable year over the total of the RIC's business interest expense for the taxable year and other deductions that are properly allocable to the RIC's business interest income (referred to as the RIC's "excess section 163(j) interest income"). These rules are based on the existing rules for reporting tax-exempt interest under section 852(b)(5) and interest related dividends in section 871(k)(1).

## General Rule for Shareholders

A section 163(j) interest dividend is treated as interest income for purposes of section 163(j). There is a cap, however, on the "conduit amounts" that a shareholder can take into account, though a RIC may report the maximum amount of certain distributions even if the sum of those reported amounts exceeds the RIC's dividends for the taxable year.[\[3\]](#) Under the final regulations, a shareholder cannot treat any part of a section 163(j) interest dividend as interest income to the extent the amount of the section 163(j) interest dividend exceeds the excess of the entire dividend over the sum of the conduit amounts (other than interest-related dividends under section 871(k)(1)(c) and section 163(j)).

“Conduit amounts” are the amounts designated by a RIC for that taxable year that are subject to a limit determined by reference to that category of income. For example, a RIC’s conduit amount with respect to its net capital gain is the amount of capital gain dividends that the RIC pays under section 852(b)(3)(C).

## **Holding Period Requirements**

A dividend from a RIC is treated as interest income under section 163(j) only if the shareholder held the RIC stock for more than 180 days during the 361-day period beginning on the date that is 180 days before the ex-dividend date, or provided that the shareholder is not under an obligation to make related payments with respect to positions in substantially similar or related property pursuant to a short sale or other transaction.

The holding period requirements do not apply to dividends paid by a RIC regulated as a money market fund under Rule 2a-7 of the Investment Company Act of 1940. They also do not apply to regular dividends paid by a RIC that declares section 163(j) interest dividends on a daily basis in an amount equal to at least 90 percent of its excess section 163(j) interest income and distributes such dividends on a monthly or more frequent basis.

## **Effective Date**

The final regulations apply to taxable years beginning on or after the date that is 60 days after the date the final regulations are published in the Federal Register. Taxpayers may choose to apply the rules in the final regulations, however, for taxable years beginning after December 31, 2017, and before the effective date of the final regulations, so long as the taxpayers and their related parties apply all of the rules consistently.

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### **endnotes**

[1] See Institute Memorandum No. 31841, dated July 9, 2019, which can be found at: [https://www.ici.org/my\\_ici/memorandum/memo31841](https://www.ici.org/my_ici/memorandum/memo31841).

[2] See Institute Memorandum No. 32661, dated August 6, 2020, which can be found at: [https://www.ici.org/my\\_ici/memorandum/memo32661](https://www.ici.org/my_ici/memorandum/memo32661).

[3] See [Rev. Rul. 2005-31](#).