MEMO# 1218

June 14, 1989

REVENUE RULING ON DISPROPORTIONATE ALLOCATIONS OF INCOME TYPE AMONG DIFFERENT CLASSES OF RIC SHAREHOLDERS

- 1 - June 14, 1989 TO: BOARD OF GOVERNORS NO. 37-89 CLOSED-END FUND MEMBERS NO. 25-89 TAX MEMBERS NO. 17-89 RE: REVENUE RULING ON DISPROPORTIONATE ALLOCATIONS OF INCOME TYPE AMONG DIFFERENT CLASSES OF RIC SHAREHOLDERS ____ Attached is IRS Revenue Ruling 89-81, which holds that disproportionate allocations of any type of income among different classes of shareholders in a regulated investment company (RIC) will be effective for federal tax purposes only to the extent that the allocation does not exceed a class' proportionate interest in that income type. The Revenue Ruling involves a closed-end RIC with a preferred and a common class of shareholders. Preferred shareholders receive fixed-rate dividends. All income eligible for the dividends received deduction (DRD) is designated by the RIC first to the preferred shareholders to the extent of their fixed dividends. Common shareholders receive all other income of the RIC, including income eligible for the DRD to the extent that the aggregate dividends received by the RIC exceed the dividends paid to the preferred shareholders. The particular facts in the Ruling are that the RIC had $100x of investment company taxable income, $50x of which was attributable to dividends received, and $100x of net capital gain. Preferred shareholders received 15% of the total dividends (or $30x) paid by the RIC in that year while the common shareholders received the remaining 85% (or $170x). All $30x of the dividends paid to preferred shareholders was designated by the RIC as dividends qualifying for the DRD. Common shareholders received $20x of dividends which were designated by the RIC as qualifying for the DRD. In addition, the RIC designated $100x of dividends paid to common shareholders as capital gain dividends. The premise for the Revenue Ruling is the IRS' view that, with one exception, "there is no evidence in the legislative history that RICs were intended to be other than straight pass- - 2 - through entities or that designations of distributions to shareholders could be made on other than a proportionate basis." Applying the Revenue Ruling's holding to the facts, the Ruling concludes that the RIC's preferred shareholders (who received only 15% of the RIC's total dividend) may treat only $7.5x (15% of $50x) of the dividends they received as dividends qualifying for the DRD. Similarly, the RIC's common shareholders may treat only $85x (85% of $100x) of the dividends they received as capital gain dividends and the RIC may include only $85x of the dividends it designated as capital gain dividends in computing its dividends paid deduction for purposes of section 852(b)(3)(A). Analogous principles apply to make ineffective non-proportionate designations of other types of income. The IRS has determined, however, that the Revenue Ruling will not be applied to render ineffective for federal tax purposes any non-proportionate designation "pursuant to a rule described in a registration statement that was filed with the Securities and Exchange Commission before June 13, 1989." We will keep you informed of developments. Keith D. Lawson Assistant General Counsel Attachment

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