



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ASSISTANCE

MEMORANDUM FOR AREA COUNSEL, SBSE:2  
Attn: Ronald D. Pinsky

FROM: Chief, CC:INTL:Br3

SUBJECT: Source of RIC Distributions to Residents of Puerto Rico

This Chief Counsel Advice responds to your memorandum dated July 2, 2001, requesting advice concerning the source of income with respect to distributions received by residents of Puerto Rico from a U.S. regulated investment company. In accordance with section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUE

What is the source of ordinary dividends and capital gain distributions paid by a regulated investment company (RIC) to a shareholder who is a bona fide resident of Puerto Rico?

CONCLUSION

Ordinary dividends paid by a RIC to a bona fide resident of Puerto Rico are U.S. source income under section 861(a)(2)(A) of the Code, except to the extent treated as foreign source income under section 853(b)(2) for purposes of the foreign tax credit. Under section 865(a)(2) and Notice 89-40, capital gain distributions paid to such shareholders are generally foreign (Puerto Rican) source income that is eligible for exemption from U.S. tax under section 933.

FACTS

A U.S. citizen who is a bona fide resident of Puerto Rico is a shareholder of a United States regulated investment company (RIC) described in section 851(a) of the Internal Revenue Code. The RIC holds a portfolio of foreign securities that

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generate income subject to foreign withholding taxes. The RIC is not subject to any net basis foreign income tax with respect to its income or gains.<sup>1</sup> The RIC has made an election under section 853(a) of the Code to allow its shareholders to claim a foreign tax credit for a proportionate share of the foreign taxes paid by the RIC, and to treat a proportionate share of dividends paid by the RIC (grossed up to include a ratable share of the foreign withholding taxes) as foreign source income for purposes of subpart A of part III of subchapter N, relating to the foreign tax credit. See section 853(b)(2). For the taxable year, the RIC distributes ordinary dividends and capital gain dividends, which are reported to its shareholders on Form 1099-DIV.

### LAW AND ANALYSIS

A RIC is a domestic corporation that elects to be a RIC and that meets certain gross income and diversification requirements. See generally section 851 of the Code. Section 852 provides rules for the taxation of RICs (which include investment companies commonly known as mutual funds) and their shareholders. Under section 852(b), a RIC generally is not subject to corporate level tax to the extent it distributes its investment company taxable income and net capital gain to its shareholders as a dividend.

Section 861(a)(2)(A) of the Code provides that dividends received from a domestic corporation (other than a corporation which has an election in effect under section 936) are treated as U.S. source income. However, section 853(a) provides, subject to certain requirements, that a RIC may elect to pass through to its shareholders the right to claim a foreign tax credit or deduction with respect to foreign income taxes it paid. Under section 853(b)(2), each shareholder of a RIC that makes this election must include in gross income and treat such income as foreign source income for purposes of the foreign tax credit under sections 901-908 the sum of (i) his proportionate share of the taxes paid by the RIC to a foreign country or possession and (2) the portion of any dividend paid by the RIC which represents income derived from foreign sources.

Accordingly, a shareholder's proportionate share of an ordinary income dividend that is attributable to foreign source income of a RIC that has made the election under section 853(a) is treated as foreign source income under section 853(b)(2)(B). However, this special source rule applies only for purposes of the foreign tax credit and does not operate to change the U.S. source of the distribution for purposes of the withholding rules or other Code provisions. Thus, an ordinary income dividend paid by a RIC is not eligible for the tax exemption provided under

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<sup>1</sup> RICs are generally not subject to net basis foreign income taxes, as it is the customary industry practice for RICs to use independent investment advisors rather than branch offices overseas to manage their foreign investments.

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section 933(1), which applies to income derived from sources within Puerto Rico by a U.S. citizen or resident alien who is a bona fide resident of Puerto Rico during the entire tax year.

While dividend distributions from a RIC are generally treated as dividends paid by a U.S. corporation, section 852(b)(3)(B) of the Code provides that a capital gain dividend from a RIC is treated by its shareholders as a gain from the sale or exchange of a capital asset held for more than one year. Section 865(a)(1) provides, with certain exceptions not relevant here, that gain from the sale of personal property is sourced based upon the residence of the seller. In the case of a United States resident, gain will generally be U.S. source income. Section 865(a)(1).

Section 865(g)(1)(A) of the Code defines the term "United States resident" for purposes of section 865 to mean any individual who is a U.S. citizen, resident alien or nonresident alien and who has a U.S. tax home (as defined in section 911(d)(3)), and any domestic corporation, trust or estate. Section 865(g)(1)(B) defines a "nonresident" as any person other than a United States resident. Section 865(g)(2) provides that a U.S. citizen or resident alien who has a foreign tax home will not be treated as a nonresident with respect to the sale of any personal property unless an income tax equal to at least ten percent of the gain derived is actually paid to a foreign country with respect to such gain. For purposes of section 865, subsection (i)(3) provides that possessions of the United States (including Puerto Rico) shall be treated as foreign countries.

Section 865(j)(3) of the Code authorizes the Secretary to prescribe regulations providing that, subject to certain conditions as may be provided in such regulations, the ten percent tax requirement of subsection (g)(2) shall not apply for purposes of sections 931, 933, and 936. Notice 89-40, 1989-1 C.B. 681, provides that for taxable years beginning after 1986, section 865(g)(2) will not apply to a person that is a bona fide resident of Puerto Rico for the entire taxable year. Thus, for example, a bona fide resident of Puerto Rico who sells stock that does not constitute inventory will not be subject to the ten percent tax payment rule of section 865(g)(2), but, instead, will be subject to the general residence of the seller rule, so that gain from the stock sale will be treated as Puerto Rican (i.e., foreign source) income regardless of whether tax is paid to Puerto Rico on the gain. Id.

Under section 852(b)(3)(B) of the Code, a capital gain dividend is treated by shareholders of the RIC as a gain from the sale or exchange of a capital asset held for more than one year. Pursuant to Notice 89-40, the source of income from the sale of personal property by persons who are bona fide residents of Puerto Rico for the entire taxable year is determined under section 865 without regard to the ten percent tax requirement of section 865(g)(2). Accordingly, capital gain distributions paid by a RIC to U.S. citizens and resident aliens who are bona fide residents of

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Puerto Rico for the entire taxable year will be considered Puerto Rican source income that is exempt from U.S. tax under section 933.

Please call (202) 622-3850 if you have any further questions.

BARBARA A. FELKER  
Chief, CC:INTL:Br3