8 T.C. 1133 (1947)

A regulated investment company can only designate as capital gain dividends those distributions actually made from realized capital gains and distributed to shareholders entitled to them, with proper notice, not distributions made from ordinary income.

Summary

Union Trusteed Funds, a regulated investment company with multiple classes of stock and segregated assets for each class, realized net long-term capital gains in only two classes. The company distributed dividends to all classes and notified shareholders that a percentage of each distribution was a long-term capital gain. The Tax Court held that the company could only deduct capital gain dividends actually paid from long-term capital gains, with proper notice, and could not designate distributions from ordinary income as capital gains dividends. This ensures that shareholders are taxed appropriately on the true nature of their distributions.

Facts

Union Trusteed Funds, Inc. was a regulated investment company authorized to issue multiple classes of stock. The assets received for each class were segregated, and earnings were distributable only to shareholders of that class. In 1942, some classes realized net long-term capital gains, while others sustained losses. The company made distributions to all shareholders and notified them that a portion was capital gain dividends, even for classes without actual capital gains.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Union Trusteed Funds' income tax. The case was brought before the United States Tax Court. The Commissioner claimed an increased deficiency, arguing against the company's method of calculating capital gain dividends.

Issue(s)

1. Whether a regulated investment company can designate distributions to shareholders as capital gain dividends when those distributions are not derived from actual capital gains realized by the specific fund associated with those shareholders.
2. Whether a regulated investment company can deduct the entire amount of capital gain dividends it designates, even if it exceeds the actual capital gains distributed to shareholders entitled to those gains.

Holding

1. No, because the statute requires the corporation to designate as capital gain dividends only those amounts that are, in law and fact, capital gains to which the shareholder-distributees are entitled.
2. No, because the deduction is limited to the capital gain dividends actually representing capital gains and distributed to the shareholders entitled to it as such, and as to which the stockholders were notified as required by the statute.

Court’s Reasoning

The court emphasized that, while the statute’s language defining capital gain dividends was ambiguous, the intent of Congress was to correlate the taxation of regulated investment companies with the taxation of their individual shareholders. The court reasoned that allowing the company to designate distributions as capital gain dividends, even when no actual capital gains were realized by the specific fund, would distort the true nature of the distributions and misrepresent shareholders’ tax liabilities.

The court stated that “Congress intended the language used by the statute to require that the corporation not designate as capital gain dividends amounts which are not, in law and in fact, capital gains to which the shareholder distributees are entitled as such.” The court disallowed the deduction for capital gain dividends exceeding the actual capital gains distributed to the shareholders entitled to it.

Practical Implications

This decision clarifies the requirements for regulated investment companies regarding capital gain dividend designations. It emphasizes that companies must track and distribute capital gains at the fund level when dealing with multiple classes of stock and segregated assets. This ensures that distributions are accurately characterized for tax purposes and that shareholders are taxed appropriately.

The case serves as a reminder that regulated investment companies cannot simply designate a portion of all distributions as capital gains to minimize their tax liability. Instead, they must correlate the designation with the actual capital gains realized and the shareholders entitled to those gains. Later cases and IRS guidance have reinforced this principle, emphasizing the importance of accurate record-keeping and allocation of capital gains within regulated investment companies.