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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE CHIEF COUNSEL (LMSB)
SAN FRANSISCO, CALIFORNIA CC:LM:CTM:SF

FROM: Associate Chief Counsel (IT&A)
CC:IT&A

SUBJECT: REQUEST FOR FIELD SERVICE ADVICE

This Field Service Advice responds to your memorandum dated November 28, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

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LEGEND
Taxpayer =
Month 1 =
Month 2 =

Year 1 =
Year 2 =
Year 3 =
$x =
$y =

ISSUE

Does Rev. Proc. 2000-38 apply to amended returns filed before the issuance of the revenue procedure?

CONCLUSION

Rev. Proc. 2000-38 applies to properly amended returns filed before the issuance of the revenue procedure. If Taxpayer properly complies with the requirements of Rev. Proc. 2000-38 for changing its method of accounting for distributor commissions to any of the three methods of accounting described in that revenue procedure, section 6.02 of Rev. Proc. 2000-38 provides that prior year treatment of distributor commissions will not be pursued.[1]

FACTS

Taxpayer is a group of corporations that provide a variety of services to more than 100 mutual funds, which are also called regulated investment companies or "RICs." Taxpayer derives most of its income from providing services to the mutual funds it creates. Prior to Month 1, Taxpayer sold only front-end load shares, i.e., where the commission on the sale was paid up-front by the investor. Taxpayer recognized the income and deducted the commission as an expense. In Month 1, however, Taxpayer began to offer shares, which are also known in the industry as "B shares," where the total commission on the sale of the mutual fund share is not recouped up-front from the investor, but is deferred and spread out over a period of time.

Starting in Month 1 Taxpayer capitalized and amortized the commissions pertaining to shares for financial accounting purposes, which is the widely accepted accounting practice in the mutual fund industry. For tax purposes for Year 1 and Year 2, Taxpayer also capitalized those commissions and amortized them over a period of about 18 months. Beginning in Year 3, however, Taxpayer treated the commissions as current expenses and deducted them on its original return.

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[1] For purposes of this memorandum the phrase "distributor commissions" has the meaning ascribed to it in section 2 of Rev. Proc. 2000-38. This memorandum does not apply to amounts that are not distributor commissions within the meaning of that section.

In Month 2, just before the CEP examination cycle was to begin, Taxpayer filed amended returns for Year 1 and Year 2, claiming deductions for the expenses of commissions, and requested refunds in the amounts of $x and $y, respectively. Taxpayer did not file a Form 3115 or any other request with the Internal Revenue Service concerning this change. During the ensuing examination, the audit team raised the issue of an unauthorized change in method of accounting with respect to Taxpayer's treatment of the commissions on the taxpayer's Year 3 original return and its Year 1 and Year 2 amended returns.

Taxpayer claims that it did not make an unauthorized change in accounting, because it was merely correcting a mistake. According to the taxpayer, at all times prior to the issuance of the shares, Taxpayer treated commissions paid on the selling of securities as ordinary and necessary business expenses for federal income tax purposes, and intended to continue that method upon the issuance of the shares. Taxpayer states that the error occurred in the preparation of the returns for Year 1 and Year 2 as a result of a simple oversight. Taxpayer claims that its original Year 1 and Year 2 returns were prepared under the erroneous assumption by its Tax Department that the commissions had been currently expensed for book purposes, and that such erroneous assumption led to the mistaken conclusion that no difference existed between the book and tax methods of accounting for commissions. When this error was discovered, Taxpayer alleges that it corrected the mistake by deducting as expenses the commissions for Year 3, and filing amended returns for Year 1 and year 2.

Taxpayer has advised the audit team that it will file a Form 3115 in accordance with Rev. Proc. 2000-38, 2000-40 I.R.B. 310 (October 2, 2000), by the end of January 2001, most likely adopting the five-year method outlined in the revenue procedure.

LAW AND ANALYSIS

Rev. Proc. 2000-38 was promulgated in order to minimize disputes in the mutual funds industry regarding the accounting for distributor commissions, and to provide appropriate methods for matching those commissions with the related distribution fees and sales charges so as to clearly reflect income. Rev. Proc. 2000-38 states "...the Internal Revenue Service will permit a taxpayer that complies with the requirements of this revenue procedure to account for distributor commissions using any of the three permissible methods of accounting described in section 5 of this revenue procedure."

Rev. Proc. 2000-38 provides three permissible methods of accounting for distributor commissions, i.e., commissions paid or incurred by a distributor of a mutual fund on the sale of mutual fund shares (typically referred to in the mutual fund industry as "B shares" and in the taxpayer's case as shares") for which the distributor is to receive a distribution fee from the mutual fund and, in some cases, a contingent deferred sales charge from the investor in future taxable year(s). The procedures for a taxpayer to obtain consent from the Commissioner of Internal Revenue to change to any of the three methods are outlined in the revenue procedure.

If a taxpayer follows the procedures outlined in Rev. Proc. 2000-38 then the revenue procedure further provides, as stated in Section 6.02, that the taxpayer will receive "Audit Protection" and "the treatment of distributor commissions will not be raised as an issue in any taxable year before the year of change and, if the treatment of distributor commissions has already been raised as an issue in a taxable year before the year of change, the treatment of distributor commissions will not be further pursued." The audit protection provisions of Section 6.02 do not differentiate between issues raised on original returns as opposed to issues raised on amended returns. Any such differentiation would be contrary to Rev. Proc. 2000-38's purpose of minimizing disputes in the mutual funds industry regarding the accounting for distributor commissions. In this case, the treatment of Taxpayer's distributor commissions was an issue being considered prior to publication of Rev. Proc. 2000-38.[2] If Taxpayer properly complies with the requirements of Rev. Proc. 2000-38 for changing its method of accounting for distributor commissions to any of the three methods of accounting described in that revenue procedure, section 6.02 of Rev. Proc. 2000-38 provides that the treatment of distributor commissions will not be further pursued.

Please call John Moriarty of this office at 202-622-4950 if you have any further questions.

Associate Chief Counsel (IT&A)
By: DOUGLAS A. FAHEY
Acting Chief
CC:IT&A:5

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[2] We note that the audit team and Taxpayer have discussed the issue of whether or not Taxpayer made an unauthorized change in method of accounting for its distributor commissions in Year 3. This memorandum assumes that it has been determined that Taxpayer did not make such an unauthorized method change. If, in fact, Taxpayer made an unauthorized change this memorandum would not apply as Taxpayer would not have filed a properly amended return for Year 1 and Year 2. In that event, Rev. Proc. 2000-38 would not afford audit protection to any of the years at issue.