

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446, 481; 1.446-1, 1.481-1.)

Rev. Proc. 2000-38

SECTION 1. PURPOSE

This revenue procedure provides three permissible methods of accounting for distributor commissions (as defined in § 2 below). A taxpayer may change to or adopt any of the three methods. This revenue procedure provides procedures for a taxpayer to obtain consent from the Commissioner of Internal Revenue to change to any of the three methods of accounting for distributor commissions, including rules relating to the limitations, terms, and conditions the Commissioner deems necessary to make the change.

SECTION 2. DEFINITIONS

Under Rule 12b-1 (17 C.F.R. § 270.12b-1), an open-end regulated investment company (“mutual fund”) may adopt, for one or more classes of its shares, a plan that permits it to use fund assets to pay a fee to cover distribution costs of fund shares (“distribution fee”). For purposes of this revenue procedure, the term “distributor commissions” means commissions paid or incurred by a distributor of a mutual fund on the sale of mutual fund 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) (typically referred to in the mutual fund industry as “B

shares”). Distributor commissions do not include commissions paid or incurred on the sale of mutual fund shares for which the distributor is to receive a distribution fee and, in some cases, a contingent deferred sales charge in future taxable years and will make commission payments to the selling broker in an amount equal to the amount it receives each year that the shares remain outstanding (typically referred to in the mutual fund industry as “C shares”).

SECTION 3. BACKGROUND

.01 Mutual funds generally distribute new shares to the public through a distributor. If an investor purchases mutual fund shares through a broker, either the investor or the distributor pays the brokerage commissions. If the distributor pays the brokerage commissions (i.e., distributor commissions), the distributor typically recovers this cost by collecting from the mutual fund a distribution fee in accordance with Rule 12b-1 and, in some cases, by receiving a sales charge from the investor if the shares are redeemed within a specified period of time.

.02 Under § 446, the Commissioner has broad authority to determine whether a method of accounting clearly reflects income. Under § 446(b), if a taxpayer's method of accounting does not clearly reflect income, the computation of taxable income must be made under a method that, in the opinion of the Secretary, does clearly reflect income. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), 1979-1 C.B. 167; Commissioner v. Hansen, 360 U.S. 446 (1959), 1959-2 C.B. 460; § 1.446-1(c)(2)(ii) of the Income Tax Regulations.

.03 To minimize disputes 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, 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 § 5 of this revenue procedure. A taxpayer may use any of these three methods to account for the distributor commissions related to each class of shares within each mutual fund for which it acts as a distributor.

.04 A change in a taxpayer's treatment of distributor commissions to any of the three permissible methods described in § 5 of this revenue procedure is a change in method of accounting to which §§ 446 and 481 apply. Sections 446(e) and 1.446-1(e) provide that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting.

SECTION 4. SCOPE

This revenue procedure applies to a taxpayer that chooses to account for distributor commissions under any of the three permissible methods of accounting for distributor commissions provided in § 5 of this revenue procedure. This revenue procedure does not apply to amortizable section 197 intangibles.

SECTION 5. PERMISSIBLE METHODS OF ACCOUNTING

.01 DISTRIBUTION FEE PERIOD METHOD.

(1) Description of Method. The treatment of distributor commissions in accordance with the distribution fee period method is a permissible method of accounting. Under

the distribution fee period method, a taxpayer must capitalize distributor commissions paid or incurred during the taxable year on the sale of shares in a mutual fund and amortize those amounts ratably over a specific recovery period determined by the number of years for which the 12b-1 plan provides the taxpayer is to receive a distribution fee from the mutual fund as a result of the sale of those shares (distribution fee period). Amortization for a short taxable year is based on the number of months in the short taxable year (taking into account the half-year convention if § 5.01(2)(b) applies).

(2) Pooling Allowed.

(a) For purposes of accounting for distributor commissions under the distribution fee period method, a taxpayer may establish one or more pools of commissions. A pool may be established with respect to distributor commissions related to a class of shares of a mutual fund sold in a single taxable year. A pool of distributor commissions may contain commissions related to a class of mutual fund shares sold in a single taxable year from one or more mutual funds, provided the distributor commissions for each class of mutual fund shares is accounted for under the distribution fee method.

However, a pool may only include distributor commissions related to a class of mutual fund shares sold in a single taxable year with the same distribution fee period and the same compensation structure.

(b) A taxpayer that establishes annual pools for purposes of using the distribution fee period method must compute the amount of the amortization deduction using a half-year convention.

(c) Distribution fees have the same compensation structure if they are calculated on the basis of the same percentage of the mutual fund's average net assets.

(3) Termination of Right to Distribution Fees.

(a) Basis recovery allowed. A taxpayer that uses the distribution fee period method described in this § 5.01 may account for the termination of its right to receive a distribution fee for a particular share in a mutual fund by claiming in the year of termination a loss or, for a sale of the distributor's right to all, or an undivided interest in a part, of its future distribution fees for the share, an offset against sales proceeds. A taxpayer that uses pools in connection with the distribution fee period method described in this § 5.01 determines its unrecovered basis in its right to receive distribution fees for particular shares in a prior year pool that are terminated by multiplying its unrecovered basis in the applicable pool of distributor commissions as of the beginning of the year by a fraction, the numerator of which is the number of terminated shares for which commissions were in the pool as of the beginning of the year and the denominator of which is the number of shares for which commissions were in the pool as of the beginning of the year. To determine the unrecovered basis for its right to receive distribution fees for a particular share in a current year pool that is terminated in the initial year (i.e., the year the share giving rise to the right to receive distribution fees is sold), the taxpayer must multiply the unrecovered basis in the applicable pool as of the end of the year by a fraction, the numerator of which is the number of shares terminated during the year for which commissions in the pool were paid or incurred during the year and the denominator of which is the number of shares sold during the year for which commissions in that pool were paid or incurred during the year. The

unrecovered basis in the applicable pool of distributor commissions must be reduced by the basis allocable to the terminated shares, as determined in the preceding two sentences, before calculating the amortization deduction for the year. If a taxpayer does not have sufficient information to relate a termination event to a specific pool, the taxpayer must treat the termination event as relating to the earliest remaining pool in accordance with the principles of § 1.1012-1(c)(1).

(b) Termination events. For purposes of § 5.01(3)(a) of this revenue procedure, a taxpayer's right to a distribution fee for a particular share terminates when the taxpayer is no longer entitled to receive a distribution fee related to that share in subsequent years. Termination may occur as a result of (i) a sale of the distributor's right to all future distribution fees for the share, (ii) the redemption of the share by the shareholder, or (iii) the conversion of the share into another class of shares for which the taxpayer is not entitled to receive a distribution fee. If a taxpayer sells an undivided interest in its right to all present and future distribution fees associated with a share or a portion of a pool, termination occurs in proportion to the interest sold.

.02 5-YEAR METHOD.

(1) Description of Method. The treatment of distributor commissions in accordance with the 5-year method is a permissible method of accounting. Under the 5-year method, a taxpayer must capitalize distributor commissions paid or incurred during the taxable year and amortize those amounts ratably over a 5-year period. Amortization for a short taxable year is based on the number of months in the short taxable year (taking into account the half-year convention).

(2) Pooling Required.

(a) For purposes of accounting for distributor commissions under the 5-year method, a taxpayer must establish one or more pools of commissions. All commissions related to a class of shares of a mutual fund sold in a single taxable year must be in the same pool. A pool of distributor commissions may contain commissions related to classes of mutual fund shares from one or more mutual funds, provided the distributor commissions for each of the classes of mutual fund shares are accounted for using the 5-year method.

(b) A taxpayer that uses the 5-year method must compute the amount of the amortization deduction using a half-year convention.

(3) Termination of Right to Distribution Fees. A taxpayer that uses the 5-year method described in this § 5.02 may not claim a loss or an offset against sales proceeds for the unamortized portion of a distributor commission as a result of a termination event for a particular share, as described in § 5.01(3)(b) of this revenue procedure. However, if the taxpayer experiences a termination event with respect to the distribution fees related to all the shares in a pool, the taxpayer may claim a loss or an offset against sales proceeds for the unamortized portion of the distributor commissions in that pool. In addition, if a taxpayer sells an undivided interest in its right to all present and future distribution fees for all the shares in a pool, the taxpayer experiences a termination event with respect to the pool, but only in proportion to the interest sold, and may claim the corresponding loss or offset against sales proceeds.

.03 USEFUL LIFE METHOD

(1) Description of Method. The treatment of distributor commissions in accordance with the useful life method is a permissible method of accounting. Under the useful life

method, a taxpayer must capitalize distributor commissions paid or incurred during the taxable year and recover those amounts over their estimated useful life. See § 1.167(a)-1(b).

(2) Determination of Useful Life. The recovery method and useful life of distributor commissions must be established by taking into account all the facts and circumstances including, for example, (i) the period during which the taxpayer is to receive distribution fees from a mutual fund under the 12b-1 plan with respect to particular shares, and (ii) the experience of the taxpayer regarding how long a typical share burdened with a given distribution fee remains outstanding after purchase. See § 1.167(a)-1(b).

(3) Pooling Allowed. For purposes of accounting for distributor commissions under the useful life method, a taxpayer may establish one or more pools of commissions. A taxpayer that establishes annual pools under the useful life method must compute the amount of the amortization deduction using a half-year convention.

(4) Retirement of Right to Distribution Fees. The determination of whether or not a taxpayer using the useful life method may claim a loss is governed by §1.167(a)-8. For example, if the useful life of the distributor commissions under the useful life method does not reflect any retirements, including a termination of a right to a distribution fee, the taxpayer may claim a loss for the unamortized portion of a distributor commission as a result of a retirement. If the useful life of the distributor commissions under the useful life method is an average useful life that reflects retirements, the taxpayer may not claim a loss for the unamortized portion of a distributor commission as a result of a retirement, regardless of whether the distributor commission is accounted for as a

single asset or in a pool, unless distributor commissions related to all the shares in the pool are retired.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING

.01 Change to the Distribution Fee Period Method, the 5-year Method, or the Useful Life Method. A taxpayer that wants to change its method of accounting for distributor commissions for the taxable year that includes January 1, 2001, to any of the three methods described in this revenue procedure must follow the automatic change in method of accounting provisions in Rev. Proc. 99-49, 1999-52 I.R.B. 725, (or its successor) with the following modifications:

(1) A taxpayer that files a copy of the Form 3115, Application for Change in Accounting Method, to change its method of accounting for distributor commissions with the national office of the Internal Revenue Service on or before April 2, 2001, is not subject to the scope limitations in § 4.02 of Rev. Proc. 99-49, unless the taxpayer's method of accounting for distributor commissions is an issue under consideration before a federal court within the meaning of § 3.09(3) of Rev. Proc. 99-49. If the taxpayer is under examination, before an appeals office, or before a federal court at the time that a copy of the Form 3115 is filed with the national office, the taxpayer must provide a duplicate copy of the Form 3115 to the examining agent, appeals officer, or counsel for the government, as appropriate, at the time the copy of the Form 3115 is filed. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent, appeals officer, or counsel for the government, as appropriate. If the taxpayer's method of accounting for distributor commissions is an issue pending within the meaning of § 6.01(6) of this revenue procedure at the time that a Form 3115 is filed

with the national office, the taxpayer also must provide to the examining agent or appeals officer, as appropriate, an executed closing agreement substantially in the form set forth in APPENDIX A of this revenue procedure.

(2) The change must be made using a cut-off method and applies only to distributor commissions paid or incurred on or after January 1, 2001. Because no items are duplicated or omitted from income when a cut-off method is used, a § 481(a) adjustment described in § 5.03 of Rev. Proc. 99-49 is not necessary. See § 2.06 of Rev. Proc. 99-49.

(3) The year of change is the taxable year that includes January 1, 2001.

(4) Section 6.02(2)(a) of Rev. Proc. 99-49 is modified to allow the required copy of the Form 3115 to be filed with the national office before the first day of the year of change if the taxpayer properly files a Form 3115 under this revenue procedure.

(5) In order to assist the Internal Revenue Service in processing changes in method of accounting under this revenue procedure, and to ensure proper handling, § 6.02(3)(a) of Rev. Proc. 99-49 is modified to require that a Form 3115 filed under this revenue procedure include the statement: “Automatic Change Filed Under [insert section number] of Rev. Proc. 2000-38.” This statement must be legibly printed or typed at the top of any Form 3115 filed under this revenue procedure.

(6) For purposes of this revenue procedure, the taxpayer's method of accounting for distributor commissions is an issue pending if the Service has given the taxpayer written notification indicating an adjustment is being made or will be proposed with respect to the taxpayer's method of accounting for distributor commissions. This will normally occur after the Service has gathered information sufficient to determine that a proposed

adjustment is appropriate and justified, although the exact amount of the adjustment may not yet be determined.

.02 Audit Protection. If a taxpayer complies with the requirements of this revenue procedure for changing its method of accounting for distributor commissions to any of the three methods of accounting described in this revenue procedure, 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.

.03 Changes Not Made under this Revenue Procedure. A taxpayer that wants to change from a method of currently deducting distributor commissions to a method of capitalizing and amortizing distributor commissions under any of the three methods described in this revenue procedure for any taxable year other than the taxable year that includes January 1, 2001, must follow the automatic change in method of accounting provisions in Rev. Proc. 99-49. However, this change must be made on a

cut-off basis as described in § 2.06 of Rev. Proc. 99-49. A change from one method of amortizing described in this revenue procedure to another method of amortizing described in this revenue procedure, and a change from pooling to single asset, or vice versa, under the distribution fee period method or the useful life method, must be made in accordance with the automatic change in method of accounting provisions in § 2.02 of the APPENDIX of Rev. Proc. 99-49. A change in the useful life of distributor commissions under the distribution fee period method or the useful life method is not a change in method of accounting. See § 1.446-1(e)(2)(ii)(b).

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective October 2, 2000.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 99-49 is modified and amplified to include this accounting method change in the APPENDIX.

DRAFTING INFORMATION

The principal author of this revenue procedure is John Moriarty of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information about this revenue procedure, contact John Moriarty at (202) 622-4950 (not a toll-free call).

APPENDIX A

Department of the Treasury Internal Revenue Service

Closing Agreement on Final Determination Covering Specific Matters

Under § 7121 of the Internal Revenue Code of 1986,

[Taxpayer's name, address, telephone number, and identifying number]

("the taxpayer") and the Commissioner of Internal Revenue make the following closing agreement:

WHEREAS, the taxpayer is a distributor of open-end regulated investment companies ("mutual funds").

WHEREAS, the taxpayer is an accrual basis taxpayer.

WHEREAS, the taxpayer incurs commissions on the sale of shares in the mutual funds for which the taxpayer is to receive a distribution fee under Rule 12b-1 (17 C.F.R. § 270.12b-1). For purposes of this closing agreement, the term "distributor commissions" has the meaning ascribed to it in Rev. Proc. 2000-38.

WHEREAS, the taxpayer seeks to account for distributor commissions under one of the methods described in Rev. Proc. 2000-38 and has filed a Form 3115 requesting permission to change its method of accounting for distributor commissions in accordance with Rev. Proc. 2000-38 and the Commissioner is relying on that Form 3115 in proceeding with this closing agreement.

NOW IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes:

1. That the taxpayer changes its present method of accounting for distributor commissions for purposes of filing federal tax returns to the [Insert name of method] method described in Rev. Proc. 2000-38 effective for the taxable year which includes January 1, 2001 ("year of change"). The Commissioner consents to that change in method of accounting.
2. That the execution of this agreement does not signify the Commissioner's agreement with the useful life or recovery method selected by the taxpayer. In accordance with § 601.204(c) of the Statement of Procedural Rules, in examining returns

involving the adoption of either the useful life method or the distribution fee period method the Commissioner will ascertain whether the representations on which the change in method of accounting is based, including representations related to the useful life of the distributor commissions, reflect an accurate statement of the material facts.

3. That the taxpayer's change in accounting method for distributor commissions must be made using a cut-off method without an adjustment under § 481(a).

4. That the Commissioner accepts the taxpayer's reported method of accounting for distributor commissions for all taxable years prior to the year of change.

5. That this agreement does not preclude the taxpayer from requesting, nor the Service from requiring, a change in the taxpayer's method of accounting for distributor commissions for years after the year of change.

This agreement is final and conclusive except:

(1) The matter it relates to may be reopened in the event of fraud, malfeasance or misrepresentation of a material fact;

(2) It is subject to the Internal Revenue Code Sections that expressly provide that effect be given to their provisions (including any stated exception for I.R.C. § 7122) notwithstanding any law or rule of law; and

(3) If it relates to a tax period ending after the date of this agreement, it is subject to any law enacted after the agreement date, that applies to the tax period.

By Signing, the parties certify that they have read and agreed to the terms of this document.

Taxpayer (other than individual):

By: _____ Date: _____
Title: _____

Commissioner of Internal Revenue

By: _____ Date: _____
Title: _____

Instructions

This agreement must be signed and filed in triplicate. (All copies must have original signatures.) The original and copies of the agreement must be identical. The name of the taxpayer must be stated accurately. The agreement may relate to one or more years.

If an attorney or agent signs the agreement for the taxpayer, the power of attorney (or a copy) authorizing that person to sign must be attached to the agreement. If the agreement is made for a year when a joint income tax return was filed by a husband and wife, it should be signed by or for both spouses. One spouse may sign as agent for the other if the document (or a copy) specifically authorizing that spouse to sign is attached to the agreement.

If the fiduciary signs the agreement for a decedent or an estate, an attested copy of the letters testamentary or the court order authorizing the fiduciary to sign, and a certificate of recent date that the authority remains in full force and effect must be attached to the agreement. If a trustee signs, a certified copy of the trust instrument or a certified copy of extracts from that instrument must be attached showing:

- (1) the date of the instrument;**
- (2) that it is or is not of record in any court;**
- (3) the names of the beneficiaries;**
- (4) the appointment of the trustee, the authority granted, and other information necessary to show that the authority extends to Federal tax matters; and**
- (5) that the trust has not been terminated, and that the trustee appointed is still acting. If a fiduciary is a party, Form 56, Notice Concerning Fiduciary Relationship, is ordinarily required.**

If the taxpayer is a corporation, the agreement must be dated and signed with the name of the corporation, the signature and title of an authorized officer or officers, or the signature of an authorized attorney or agent. It is not necessary that a copy of an enabling corporate resolution be attached.

Use additional pages if necessary, and identify them as part of this agreement.

Please see Revenue Procedure 68-16, C. B. 1968 1, page 770, for a detailed description of practices and procedures applicable to most closing agreements.

[INSERT TAXPAYER'S NAME]

**I have examined the specific matters involved and
recommend the acceptance of the proposed
agreement**

(Receiving Officer)

(Date)

(Title)

**I have examined the specific matters involved and
recommend the acceptance of the proposed
agreement**

(Reviewing Officer)

(Date)

(Title)