

INTERNAL REVENUE SERVICE

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1278.02-00

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Date: January 15, 1999

Legend

Fund =

State =

X =

Accountant =

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This ruling is in response to your letter dated January 15, 1998, requesting a ruling that Fund did not change its method of accounting for market discount by attaching certain election statements to its income tax return for the tax year ending on January 31, 1997.

FACTS

Fund is a business trust organized in 1983 under the laws of State. Fund has in each year since inception qualified as a regulated investment company (RIC) under Subchapter M of the Internal Revenue Code and has filed its federal income tax return as a RIC using a tax year ending on January 31.

Fund is part of a family of over 100 funds managed by X. Fund invests in municipal obligations, the interest on which is exempt from federal income tax under § 103 of the Code, and Fund has qualified each year to pay exempt interest dividends under § 852(b)(5). Fund has invested in certain exempt obligations that are market discount bonds under § 1278(a)(1).

Accountant was engaged by X to prepare the federal income tax returns for 20 of the funds

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managed by X for the tax year ending on January 31, 1997. Fund is the only fund in this group that invests in exempt obligations. During the tax return preparation process, X's Vice President & Director of Tax specifically instructed Accountant to make the § 1278(b) election to include market discount in income currently, and the § 1276(b)(2) election to calculate market discount using the constant interest method for taxable bonds in all X funds for which returns were being prepared. X did not intend to make the election for any tax exempt bonds nor did it instruct Accountant to do so.

On September 24, 1997, Accountant presented the returns to X for final review and signature. Fund's return was filed on October 1, 1997. On November 17, 1997, after the return was filed, management of Fund noticed that the return erroneously included a one page statement purporting to make the § 1278(b) and § 1276(b)(2) elections. This statement was similar to the statements that were filed with the tax returns for other funds in the group. The election statement had not been noticed when X reviewed the tax return prior to filing and X had no actual knowledge that it was included in the return. On January 15, 1998, this ruling request was submitted. Upon investigation by X and Accountant, it was discovered that the election was erroneously attached when the Fund's tax return was assembled along with the tax returns for the other 19 funds.

Consistent with its intent to continue to recognize market discount upon disposition of the bond under § 1276(a) and to accrue market discount using ratable accrual, Fund's return for the taxable year ending on January 31, 1997, did not reflect these elections. Rather Fund continued to defer recognition of market discount for the market discount bonds held by Fund.

Additionally, a supporting schedule listing the amount of market discount on bonds disposed of during the tax year ending on January 31, 1997 that was reclassified from capital gain to ordinary income includes market discount from the disposition of bonds that would have been subject to the erroneous § 1276(b)(2) election. The reclassified amounts were accrued using ratable accrual rather than constant yield. Thus, Fund continued to calculate market discount using the ratable accrual method pursuant to § 1276(b)(1), as it had done in prior years.

LAW

Section 1276(a)(1) provides that gain on the disposition of any market discount bond shall be treated as ordinary income to the extent that it does not exceed the accrued market discount on the bond.

In general, a bond has market discount if the basis of the bond immediately after its acquisition by the taxpayer is less than the stated redemption price of the bond at maturity. Section 1278(a)(2). A bond is defined as any bond, debenture, note, certificate or other evidence of indebtedness. Section 1278(a)(3). However, a market discount bond does not include an obligation with a maturity date of one year or less, a U.S. savings bond, or an installment

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obligation to which § 453B applies. Section 1278(a)(1)(B).

In lieu of including accrued market discount in income as required by § 1276 (a), a taxpayer may elect to include accrued market discount in income currently. Section 1278(b). This election applies to all market discount bonds acquired by the taxpayer on or after the first day of the first taxable year to which the election applies.

Accrued market discount for a bond is generally determined under a ratable formula. Section 1276(b)(1). Alternatively, a taxpayer may irrevocably elect to compute accrued market discount on the basis of a constant interest rate calculation. Section 1276(b)(2). Under the alternative calculation the constant interest rate is determined as if the bond were issued on the date acquired by the taxpayer for an amount equal to the taxpayer's basis.

Section 1.446-1(e)(3)(i) of the regulations delegates to the Commissioner the Secretary's authority to consent to a change in accounting method, and provides that permission to change a taxpayer's method of accounting will not be granted unless the taxpayer agrees to the Commissioner's prescribed terms and conditions for effecting the change.

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, including such procedures as may be necessary to prevent the omission or duplication of terms includible in gross income or deductions.

Rev. Proc. 92-67, 1992-2 C.B. 429, provides procedures for taxpayers to make elections to change their methods of accounting under §§ 1276(b) and 1278(b). The consent of the Commissioner is automatically granted if the change is effected in accordance with the terms of the revenue procedure. Section 6 of Rev. Proc. 92-67.

Section 3.02 of Rev. Proc. 92-67 provides the procedures for making a § 1278(b) election. An otherwise qualified taxpayer makes a § 1278(b) election by attaching to the taxpayer's timely filed income tax return for the election year a statement that market discount has been included in the gross income of the taxpayer under § 1278(b) of the Code. The statement must also describe the method used by the taxpayer to determine the market discount attributable to the taxable year covered by the tax return. The election applies to all market discount bonds acquired on or after the election date.

Section 4.02 of Rev. Proc. 92-67 provides the procedures for making a constant interest rate election under § 1276(b). An otherwise qualified taxpayer makes a constant interest rate election for the bond by attaching to a timely filed tax return a statement identifying the bond and

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stating that the taxpayer is making a constant interest rate election with respect to the bond.

ANALYSIS

Fund attached an election statement to a timely filed federal tax return stating that it elected to calculate market discount using the constant yield method under § 1276(b)(2) and accrue marked discount currently under § 1278(b). However, Fund did not implement the change in its books and records or on its tax return. Fund argues that the election was erroneous and that it should be allowed to continue using its prior method of accruing and recognizing market discount.

Section 3 of Rev. Proc. 92-67 sets forth the procedure for making a valid § 1278(b) election and requires the taxpayer to attach a statement to the return that it is making the election and that the market discount has been included. In addition, the statement must also describe the method used by the taxpayer to determine market discount accrued in the year of the election. In order for an election statement to meet this requirement the representation that market discount was included must be true and accurate. Although the election statement included a representation that market discount was included in income currently and computed under the constant yield method, this was in fact not the case. Accordingly, the election statement fails to meet the requirements of section 3 of Rev. Proc. 92-67.

Section 6 of Rev. Proc. 92-67 requires that the taxpayer actually change its method of accounting in order to avail itself of the grant of automatic consent in that section. The previously filed tax return, documents and supporting schedules submitted and representations made under penalty of perjury indicate that the taxpayer did not change its method of accounting. Accordingly, the taxpayer did not comply with the requirement set forth in section 6 of Rev. Proc. 92-67 for obtaining the Commissioner's consent to change.

We conclude that the taxpayer did not comply with all the terms and conditions set forth in Rev. Proc. 92-67, and will not be deemed to have changed its method of accounting for market discount. Moreover, the taxpayer did not change its method of accounting for market discount for the tax year ending in January 31, 1997, and should continue to recognize market discount upon disposition of the bonds, and should continue to calculate market discount using the ratable method pursuant to § 1276(b)(1), consistent with its method of accounting used previously.

Except as specifically ruled upon herein, we express no opinion concerning any federal income tax consequences relating to the facts herein under any other section of the Code.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this ruling should be attached to Fund's future federal tax returns.

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Additionally, Fund must include a copy of the ruling with any future request or election to change its method of accounting for market discount under §§ 1278 or 1276.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By Richard C. Hoge
Richard C. Hoge
Assistant to the Chief, Branch 1

Enclosures:

Copy of this letter

Copy for § 6110 purposes