Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:BOS:TL-N-1762-01
MJGormley

date:

to: Woody K. Howell, Territory Manager
LMSB (FSH)

from: Associate Area Counsel, (LMSB)
Area 1

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subject: **Mutual Fund Withholding**
UIL# 851.00-00

This memorandum responds to your request for advice dated March 30, 2001, regarding the proper terms of a closing agreement with a mutual fund to correct a prior deficit in withholding on capital gains. This memorandum should not be cited as precedent.

ISSUE

What is the proper vehicle to resolve a mutual fund's deficit in withholding on capital gains where the mutual fund would be subject to an excise tax on the undistributed amounts of income under I.R.C. § 4982.

CONCLUSION

If the threshold requirements of the Information Reporting Program Closing Agreement Procedures are met, the mutual fund may enter into a closing agreement (Form 906) with the Service wherein it agrees to pay a compliance fee, computed at a rate of 31%, applied to the total amount of understated reportable income. This payment will be in lieu of tax, interest and any potential penalties.

FACTS

The facts set forth below, and upon which this advice is based, are as stated by your office in your memorandum dated March 30, 2001, and as supplemented by a letter from the taxpayer's representative dated April 11, 2001. If our understanding of the facts is not correct, or if the facts have changed in any way, you should not rely on this advice but rather

seek modified advice based on the changed circumstances.

A regulated investment company (RIC) has made an error in its year-end capital gains distribution to its shareholders for the calendar year [redacted]. The RIC had a required distribution of capital gains income of approximately $[redacted]. Due to an arithmetic error, it distributed approximately $[redacted]. This left an undistributed capital gain in the amount of $[redacted]. Shareholders in the mutual fund, the RIC, included fully taxable shareholders and tax deferred shareholders such as section 401(k) plans, IRA's and the like. Based on the taxpayer's review, approximately [redacted]% of the shareholders in the fund would currently be subject to tax. Therefore, of the $[redacted] of undistributed capital gain, only [redacted]% or $[redacted] would be subject to tax at capital gains rates. Assuming a full capital gains rate of 20%, the underpayment of tax totals approximately $[redacted].

As a result of this underreporting error, the RIC is subject to a 4% excise tax imposed by I.R.C. § 4982. It is also subject to information return penalties under I.R.C. § 6723 for failure to include correct information on its payee statements.

The RIC discovered the oversight and has voluntarily contacted the Service and disclosed the error. It claims the error was inadvertent and that in the past, the fund has fully complied with its distribution and reporting requirements. In order to resolve the underreporting issues, the RIC initially proposed entering into a closing agreement (Form 906) with the Service whereby the RIC will be charged interest from [redacted] to [redacted] for the unreported capital gain. It would distribute the capital gain in the year [redacted] and the recipient shareholders would report their respective portion of the gain on their individual returns in [redacted]. The representative for the RIC implied the Service would not then require the RIC to file an excise tax return and report the 4% penalty.

The RIC has since proposed an alternate resolution. It now wished to enter into an agreement with the Service whereby it the will make a compliance contribution to the Service to insure that "the Treasury is made whole for any loss on the timing of the payment of capital gains tax," in exchange for relief from any additional tax or penalties.

You have requested our advice regarding the RIC's proposal. Specifically, you have inquired whether the use of a Form 906 closing agreement is the proper procedure to use in order to resolve these issues. You are also seeking our opinion regarding the substantive content of the closing agreement.

Legal Analysis

A regulated investment company (RIC) is generally treated as a conduit for income tax purposes. The RIC's taxable income, which is distributed to investors each year, is taxed to them without being taxed at the corporate level. This is accomplished by allowing the RIC a deduction for distributions paid to its shareholders. RICs can generally deduct dividends paid to shareholders from investment company taxable income and net capital gains.[1]

An excise tax is imposed on certain undistributed income of a regulated investment company (RIC). I.R.C. § 4982(a). The tax is equal to four percent of the excess of (1) the required distribution for the calendar year, over (2) the distributed amount for the calendar year. The tax is payable on or before March 25 of the following calendar year.[2] The required distribution is the sum of 98% of the RIC's ordinary income for the year, plus 98% of the RIC's capital gain net income for the one year period ending on October 31 of the calendar year. I.R.C. § 4982(b)(1). This is increased by any excess of grossed up required distribution over the distributed amount for the

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[1] If RICs meet certain requirements, they can pass through the character of certain types of income and deductions. Capital gains and net tax-exempt interest income may retain their character when distributed to shareholders. I.R.C. §§ 852(b)(3)(B) and 852(b)(5)(B). To qualify for conduit treatment, the RIC must distribute at least the sum of (1) 90% of its investment company taxable income for the tax year determined without regard to capital gain dividends and exempt interest dividends and (2) 90% of the excess of its exempt interest income over the expenses, including amortization of bond premium, of earning the exempt interest. I.R.C. § 852(a). When an investment company fails to satisfy the distribution requirements, it is ineligible to take the dividends-paid deduction and is taxed on its net investment company taxable income and net capital gains as a C corporation. In addition, failing to satisfy the distribution requirement prevents the fund from passing through capital gains, exempt interest dividends, dividend income qualifying for the dividends-received deduction, or foreign taxes to shareholders.

[2] Form 8613, Return of Excise Tax on Undistributed Income of Regulated Investment Companies is to be used by RICs to report the excise tax.

preceding calendar year. I.R.C. § 4982(b)(2). For purposes of this subsection, the term grossed up required distribution for any year is the sum of the taxable income of the RIC for the year and all amounts from earlier years that are not treated as having been distributed under this provision. I.R.C. § 4982(b)(3).[3]

In order to compute the amount of net capital gain that must be distributed by a RIC so as to avoid the excise tax imposed by I.R.C. § 4982, RICs are allowed to offset their net capital gains by their net ordinary losses that were incurred during the same year. Such losses are generally equal to a RIC's net operating losses. However, when a RIC has not made an election to use its own tax year for purposes of computing the excise tax, and if the RIC's tax year does not end on October 31, the RIC's earnings and profits for such purpose will be determined without regard to any net capital losses or net foreign currency losses attributable to transactions occurring after October 31. I.R.C. § 4982(e)(2).

I.R.C. § 4982(f) provides an exemption of a RIC from excise tax. A RIC that is for the entire calendar year wholly owned by any combination of certain types of exempt organizations or segregated asset accounts of a life insurance company is exempt from the excise tax on its undistributed income. In order to qualify for this exclusion, the exempt organization must be a qualified pension, profit-sharing or stock bonus plan described in Code § 401(a) and exempt from taxation under Code § 501(a) and the segregated asset account of a life insurance company must be held in connection with variable contracts defined in I.R.C. § 817(d). There is no information available to us to indicate this exemption is applicable to the facts of this case. Therefore, it would appear the RIC would be liable for the 4% excise tax on its undistributed income under I.R.C. § 4982.

It also appears that the RIC would be liable for information return penalties under I.R.C. § 6721. In accordance with I.R.C. § 6721(a)(2)(B) the inclusion of incorrect information on an information return, including an incorrect monetary amount may result in a penalty of $50 for each return up to a maximum of $250,000.00. I.R.C. § 6721(a)(1). A nonpublically offered RIC is required to file an information return with the IRS for each affected investor (income recipient) on or before February 28th

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[3] The distributed amount under this provision is the sum of the dividends paid deduction during the calendar year and any amount taxed to the RIC as investment company taxable income or capital gains. This amount is increased by the distributed amount for the preceding calendar year to the extent that it exceeds the grossed up required distribution for that year.

of the following year. Treas. Reg. §§ 1.67-2T(n),1.67-2T(n)(3). Errors made on such information returns, if corrected within 30 days after the required filing date, may result in a reduced penalty of $15.00 per return up to a maximum of $7,500.00. I.R.C. § 6721(b)(1). If the error is corrected after the 30th day following the required filing date but before August 1 of the following year, the penalty will be $30.00 per return up to a maximum of $150,000.00.

The RIC may also be liable for penalties under I.R.C. § 6722 for failure to furnish correct payee statements. In accordance with Treas. Reg. § 1.67-2T(n)(1)(ii), the RIC is required to furnish payee statements to each affected investor on or before January 31st of the following year. Treas. Reg. § 1.67-2T(n)(4). Inclusion of incorrect information on such payee statements may result in a penalty of $50.00 per statement up to a total of $100,000.00

With regard to the use of a Form 906 closing agreement to resolve the issues pending in this case, the Service's "Closing Agreement Handbook" provides for an information return closing agreement (IRP-CAP). This is an agreement made in writing between the Service and a payer of income when a mass error has been made that effects a high volume of information returns issued by that payer, but only involves a de minimis amount of understated reportable income for a single Form 1099. This agreement would relieve the payer from having to file corrected payee returns with the IRS and from having to issue corrected payee statements in order to avoid penalties under I.R.C. §§ 6721-6724. This type of agreement would also relieve the payee from having to file amended tax returns.

Commonly, the closing agreements provide that the taxpayer will pay to the Service a "compliance fee", satisfying its liability under I.R.C. §§ 6721 and 6722 arising from the understatement or underreporting of reportable income. The taxpayer is not then required to file corrected information returns and the payees are not required to include any of the underreported amounts in their gross income. The compliance fee is not deductible or otherwise amortizable or recoverable for tax purposes by the taxpayer for any tax year, nor is it refundable or subject to credit or offset. Generally, at the time of the closing agreement, the taxpayer has identified and fixed the errors involved and voluntarily approached the Service requesting a final resolution of its liability.

Certain requirements must be met before these closing agreements can be utilized. First, the payer must voluntarily bring the error to the attention of the Service. Second, the

payer cannot make the same or similar errors repeatedly. Third, the dollar amount of the understated reportable income for each payee for a given account for a particular tax year must be de minimis, an amount less than $50.00. A listing must be provided by the payer that reflects the amount that was actually reported and the amount that should have been reported for each payee account. Since the individual tax returns of the payees will not be used, an estimate of an amount that will be paid by the payer in lieu of tax must be determined in order to determining the amount of the compliance fee. In cases of underreported income, a rate of 31% will be applied to the total amount of understated reportable income. This payment is considered in lieu of tax, interest and any potential IRP penalties. This procedure is available for all forms in the Form 1099 series and if the criteria set forth above are met, the Service will readily consider such an agreement.

We note that an April 27, 1998 memorandum from the Assistant Commissioner, Examination, specifically discusses the closing agreement discussed above and notes this procedure is intended to reduce burdens on taxpayers, improve customer service and should be used in all appropriate situations. Given all of the above, we believe that a Form 906 closing agreement is an appropriate vehicle to resolve the dispute between the parties. Moreover, the imposition of a "compliance fee" of 31% in lieu of tax, interest and penalties which would otherwise be imposed would appear to fairly resolve the issues in dispute and serve the interests of both the taxpayer and the Service. However, before any such agreement can be reached, the Service must first determine that requirements of the IRP-CAP program as outlined above are met.

Conclusion

If the taxpayer is able to satisfy the IRP-CAP requirements, it may enter into a closing agreement (Form 906) with the Service wherein it agrees to pay a compliance fee, computed at a rate of 31%, applied to the total amount of understated reportable income. This payment will be in lieu of tax, interest and any potential penalties.

If you need further assistance, please contact the undersigned at 617/565-7858.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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By: _____
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