

certificate credit for low-income homeowners (§ 1306), the foreign tax credit for regular income tax (§ 2475), and the District of Columbia first-time homebuyer credit (§ 1308).

The amount of general business credit that a taxpayer can claim during a tax year may not exceed the sum of the taxpayer's combined regular tax liability and AMT liability, less the above nonrefundable personal tax credits, and less the greater of (1) the taxpayer's tentative minimum tax, or (2) 25 percent of the taxpayer's net regular tax liability over \$25,000 (§ 1365) (Code Sec. 38(c)).<sup>30</sup> However, several specified credits are allowed to the full extent of the taxpayer's combined regular tax and AMT liability, although they may be subject to particular limitations specific to the individual credit. These credits include the alcohol fuels credit (§ 1365D), the low-income housing credit (§ 1365K), the renewable electricity production credit (§ 1365N), the FICA employer tip credit (§ 1365R), the railroad track maintenance credit (§ 1365W), the small employer health insurance credit (§ 1333), the rehabilitation credit (§ 1365B), the business energy credit (§ 1365C), the work opportunity credit (§ 1365G), and certain eligible small business credits (§ 1365). The limitation is made separately for the empowerment zone employment credit, substituting 75 percent of tentative AMT for 100 percent of AMT.

**1480. AMT and Possessions Tax Credit.** Corporate income for which the Puerto Rican economic activity credit or the possessions tax credit may be claimed (§ 1362) is not includible in AMTI and therefore is not subject to the minimum tax (Code Sec. 59(b)).<sup>31</sup>

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>30</sup> § 4250; BUSEXP: 54,056; § 15,515.15

<sup>31</sup> § 5400; INTL: 27,066

## Chapter 15

### TAX ACCOUNTING

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#### Accounting Period

**1501. Tax Year.** Taxable income is computed on the basis of a period called a tax year. A tax year is the annual accounting period regularly used by a taxpayer in keeping its books and records to compute income. This period is usually a calendar year or a fiscal year. A calendar year is a period of 12 months ending on December 31. A fiscal year is a period of 12 months ending on the last day of any month other than December; a 52-53 week fiscal year, however, may end on a different day of the month (§ 1503). Special rules exist when a taxpayer must file a return for a period that is less than 12 months (short-period return) (§ 1505) (Code Sec. 441).<sup>1</sup>

**Example 1:** A corporation began doing business on August 15, 2012. The end of its first tax year cannot be later than July 31, 2013, because a tax year may not cover more than a 12-month period and must end on the last day of a month, unless it is a 52-53-week tax year.

A new taxpayer may adopt either a calendar or a fiscal year on their first tax return, but certain taxpayers are required to adopt a specific tax year (Reg. § 1.441-1).<sup>2</sup> An existing taxpayer that wants to change its tax year must follow IRS procedures (§ 1513). If a taxpayer adopts an improper tax year, such as a fiscal year (other than a 52-53 week tax year) that does not end with a calendar month, the IRS may require the taxpayer to adopt a proper tax year or to request IRS approval to change tax years (§ 1513) (Rev. Rul. 85-22).<sup>3</sup>

**Example 2:** Assume that the new corporation in Example 1 determines there is no advantage in keeping its books on the basis of any year other than the calendar year. Therefore, it adopts the calendar-year basis. It should close its books as of December 31, 2012, and file its first return for the short period from August 15, 2012, through December 31, 2012. This is its first tax year. All its later tax years will be full calendar years until its dissolution or until it changes to a fiscal year.

A fiscal year will be recognized only if it is established as the taxpayer's annual accounting period and only if the taxpayer keeps his or her books accordingly. A taxpayer who has no annual accounting period, does not keep adequate records, or whose present tax year does not qualify as a fiscal year must compute taxable income on a calendar-year basis (Reg. § 1.441-1).<sup>4</sup>

A partnership generally must use the same tax year as that of its owners unless the partnership can establish a business purpose for having a different tax year (Code Sec. 706(b); Reg. § 1.706-1).<sup>5</sup> The tax year of the owners for this purpose is the tax year of the

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>1</sup> § 20,302; ACCTNG: 24,050; § 38,101

<sup>3</sup> § 20,307.70; ACCTNG: 24,058; § 38,135.20

<sup>5</sup> § 25,160, § 25,161; ACCTNG: 24,352; § 30,120.05

<sup>2</sup> § 20,303; ACCTNG: 24,052; § 38,105

<sup>4</sup> § 20,303; ACCTNG: 24,056; § 38,110

partner(s) owning the majority interest in the partnership—the tax year of the partner(s) owning in total more than a 50-percent interest in partnership profits and capital (§ 416). If there is no majority interest tax year, the partnership must adopt the same tax year as that of its principal partners, each of whom must have at least a 5-percent interest in partnership profits or capital. When neither condition is met, the partnership must use the tax year that produces the least aggregate deferral of income to the partners.

An S corporation or a personal service corporation (PSC) (§ 273) must generally use the calendar year unless the entity can establish a business purpose for having a different tax year (Code Secs. 441(i) and 1378(b)).<sup>6</sup> For this purpose, a corporation is not considered a PSC unless more than 10 percent of its stock (by value) is held by employee-owners. If a corporation is a member of an affiliated group filing a consolidated return, all members of that group must be considered in determining whether the corporation is a PSC.

Certain partnerships, S corporations, and PSCs may elect on Form 8716 to use a tax year other than a required tax year (Code Sec. 444).<sup>7</sup> To neutralize tax benefits resulting from such a tax year, electing partnerships and S corporations must compute and make any required payments (i.e., the amount of tax that would otherwise be due from partners and stockholders had those entities used the required tax year) exceeding \$500 (Code Sec. 7519).<sup>8</sup> The required payment is due on or before May 15 of the calendar year following the calendar year in which the election year begins (Temp. Reg. § 1.7519-2T(a)(4)).<sup>9</sup> Electing PSCs must make minimum distributions to their employee-owners by the end of a calendar year falling within a tax year to avoid certain deduction deferrals for amounts paid to employee-owners (Code Sec. 280H).<sup>10</sup>

Generally, the Section 444 election must be made by the earlier of: (1) the 15th day of the fifth month following the month that includes the first day of the tax year for which the election is first effective or (2) the due date (without extensions) of the return that results from the election (Temp. Reg. § 1.444-3T(b)(1)).<sup>11</sup> The election remains in effect until an entity changes its tax year or otherwise terminates such an election (Code Sec. 444(d)).<sup>12</sup> The election may not be made by an entity that is a member of a tiered structure unless the tiered structure consists only of partnerships or S corporations (or both), all of which have the same tax year.

Common trust funds (certain investment funds maintained by a bank; § 2359) are required to adopt the calendar year as their tax year (Code Sec. 584(i)).<sup>13</sup>

The tax year of a domestic international sales corporation (DISC) (§ 2498) must be the same as that of the shareholder or group of shareholders with the same tax year who have the highest percentage of voting power. Voting power is determined on the basis of total combined voting power of all classes of stock of the corporation entitled to vote. If two or more shareholders or groups are tied for the highest percentage, the tax year used is that of any such shareholder or group (Code Sec. 441(h)).<sup>14</sup>

**1503. 52- or 53-Week Accounting Period.** A taxpayer may elect to use a fiscal tax year that varies from 52 to 53 weeks if that period always ends on the same day of the week (Monday, Tuesday, etc.) and that day is either the last such day in a calendar month or the closest such day to the last day of a calendar month (Code Sec. 441(f); Reg. § 1.441-2).<sup>15</sup>

**Example:** A new taxpayer wishes to have its accounting period end on the last Saturday in August. In 2012, its tax year ends on August 25, completing a 52-week year (August 28, 2011, through August 25, 2012). In 2013, its tax year ends on August 31, completing a 52-week year (August 26, 2012, through August 31, 2013).

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>6</sup> ¶ 20,302; ¶ 32,260; ACCTNG: 24,354; ACCTNG: 24,356; § 27,120, § 28,410.15	<sup>9</sup> ¶ 42,773; ACCTNG: 24,504.05; § 38,115.10	<sup>12</sup> ¶ 20,600; ACCTNG: 24,458; § 38,115.05
<sup>7</sup> ¶ 20,600; ACCTNG: 24,450; § 38,115.05	<sup>10</sup> ¶ 15,160; ACCTNG: 24,550; § 38,115.15	<sup>13</sup> ¶ 23,630; RIC: 12,304.15
<sup>8</sup> ¶ 42,770; ACCTNG: 24,500; § 38,115.10	<sup>11</sup> ¶ 20,604; ACCTNG: 24,454; § 38,115.05	<sup>14</sup> ¶ 20,302; ACCTNG: 24,110.10
		<sup>15</sup> ¶ 20,302; ¶ 20,304; ACCTNG: 24,302; § 38,105

¶1503

With this type of tax year, most of the taxpayer's tax years are 52 weeks long. As an alternative, the taxpayer could select a tax year that ends on the Saturday that is nearest to the end of August. In 2012, therefore, the tax year ends on September 1 (the Saturday nearest the end of August). In 2013, the tax year will end on August 31.

If a pass-through entity or an owner of a pass-through entity, or both, use a 52-53-week tax year and the tax year of the entity and owner end with reference to the same calendar month, then for purposes of determining the tax year in which items of income, gain, loss, deductions, or credits from the entity are taken into account by the owner, the owner's tax year will be deemed to end on the last day of the entity's tax year. Under this rule, a pass-through entity is a partnership, S corporation, trust, estate, closely held real estate investment trust, common trust fund, controlled foreign corporation, foreign personal holding company, or passive foreign investment company that is a qualified electing fund (Reg. § 1.441-2(e)).<sup>16</sup>

**1505. Short-Period Return.** A return for a period of less than 12 months may need to be filed by a taxpayer who changes its annual accounting period (§ 1513) or is in existence during only part of what would otherwise be the tax year (Code Sec. 443; Reg. § 1.443-1).<sup>17</sup>

Taxpayers who are not in existence for a full 12-month period include:

- (1) a corporation that begins business or goes out of business at any time other than the beginning or end of its accounting period,
- (2) an individual taxpayer who dies prior to the end of the accounting period, and
- (3) a decedent's estate that comes into existence on the date of the decedent's death and adopts an accounting period ending less than 12 months from that date.

If the taxpayer is not in existence for a full tax year, the tax is computed as if the return had actually covered a full tax year. When a short period occurs as a result of a change in accounting period, the tax is computed on an annualized basis (§ 1507). An alternative relief method is also available for taxpayers that change their accounting period (§ 1509). Short-period returns of decedents and dissolving corporations, and the first return of a new corporation, however, are not required to be annualized.

If a change to or from a 52-53 week tax year results in a short period of 359 days or more, the tax is computed as if the return had actually covered a full tax year. If the short period is less than seven days, the short period becomes a part of the following tax year. If the short period is more than six days but less than 359 days, the tax is computed under the annualized method (Code Sec. 441(f)(2)).<sup>18</sup> Special annualization rules apply to taxpayers that make such a change (§ 1507).

**1507. Method for Annualizing Income for Short Periods.** When there has been a change in an accounting period that necessitates the filing of a short-period return (§ 1505), income for the period must be converted to an annual basis. This conversion is accomplished by: (1) multiplying the taxpayer's modified taxable income for the short period by 12 and (2) dividing the result by the number of months in the short period. Then the tax is computed on the resulting taxable income by using the tax rate schedules and not the tax tables for individuals. The tax so computed is divided by 12 and multiplied by the number of months in the short period (Code Sec. 443).<sup>19</sup>

The modified taxable income for the short period is the gross income for the period less any allowable deductions (other than the standard deduction) and an adjusted personal exemption amount. Actual itemized deductions for the short period are allowed in lieu of the standard deduction amount. The adjusted personal exemption amount is

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>16</sup> ¶ 20,304; ACCTNG: 24,308; § 38,105	<sup>18</sup> ¶ 20,302; ACCTNG: 24,306; § 38,140.15
<sup>17</sup> ¶ 20,500; ¶ 20,501; ACCTNG: 24,250; § 38,140.05	<sup>19</sup> ¶ 20,500; ACCTNG: 24,260; § 38,140.10, § 38,140.15

¶1507

the total of an individual taxpayer's personal exemptions times the ratio of the number of months in the short period to 12.

**Example:** Tom has been making his returns on the basis of a fiscal year ending April 30. He changes to a year ending June 30 in 2012. He must file his return for the year ending April 30, 2012, on or before August 15, 2012. On or before October 15, 2012, he must file his return for the short period of two months beginning May 1, 2012, and ending June 30, 2012. His gross income for the short period is \$9,600, and his itemized deductions total \$600. He is married, age 60, and has no dependents. His wife has no income or deductions. The tax before credits on their joint return is computed as follows:

Gross income	\$9,600
Itemized deductions*	600
Net income	9,000
Less 2/12 of \$7,600 (2 × \$3,800) exemptions	1,267
Modified taxable income for short period	7,733
Annualized taxable income—\$7,733 × 12/2	46,398
Tax on \$46,398	6,090
Tax for short period, 2/12 of \$6,090	1,015

\* Assume that the itemized deductions are not miscellaneous itemized deductions and that amounts are rounded up to the nearest dollar. An individual making a short-period return because of a change in annual accounting period is not eligible for the standard deduction (Code Sec. 63(c)(6)(C)).

When a short-period return is filed, the taxpayer's self-employment tax (¶ 2664) should be computed on the actual self-employment income for the short period and not prorated for a portion of a 12-month period.<sup>20</sup> A net operating loss deduction should be applied against actual income for the short period before annualizing (Rev. Proc. 2002-39, modified by Rev. Proc. 2003-34 and Rev. Proc. 2003-79).<sup>21</sup>

A taxpayer that is changing to or from a 52-53-week fiscal tax year and that must annualize income will apply the same rules as other taxpayers in determining the income of the short period, but will calculate income on an annual basis by multiplying the income of the short period by 365 and dividing the result by the number of days in the short period (Code Sec. 441(f)(2)(B)(iii)). Tax is computed on that annualized income and, as computed, is multiplied by the ratio of the number of days in the short period to 365; the resulting figure is the tax for the short year.

**1509. Alternative Method for Annualizing Income for Short Periods.** An alternative method is provided for annualizing income when computing tax for a short-period return (¶ 1505) (Code Sec. 443(b)(2); Reg. § 1.443-1(b)(2)).<sup>22</sup> Under this method, the tax for the short period is the greater of:

- (1) a tax on the actual taxable income for the 12-month period beginning with the start of the short period (using the law in effect for that 12-month period) multiplied by the modified taxable income (¶ 1507) for the short period and divided by the modified taxable income for the 12-month period, or
- (2) a tax on the modified taxable income for the short period.

If a taxpayer does not exist at the end of the 12-month period described in (1), above, or if a corporate taxpayer has distributed substantially all its assets before the end of that period, the tax is computed by using a 12-month period ending with the last day of the short period. In such cases, in order to claim the benefits of the alternative method, the taxpayer must attach a return covering the 12-month period ending on the last day of the short year to the return initially computed for the short period.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>20</sup> ¶ 35,203.30; INDIV: 63,058; § 38,140.15

<sup>21</sup> ¶ 20,406; ACCTNG: 24,260; § 38,140.15

<sup>22</sup> ¶ 20,500, ¶ 20,501; ACCTNG: 24,260.15; § 38,140.25

If there was a change in accounting period resulting in a short period, the taxpayer must first compute the tax using the general annualization method and file the return. If the alternate method would result in lower taxes, a claim for credit or refund must be filed no later than the due date by which a return would have been required to be filed if the 12-month period beginning with the short period were considered a tax year. The application of the taxpayer for use of the alternate method is considered as a claim for credit or refund.

**1513. Change of Accounting Period.** The change from one accounting period to another generally requires prior permission of the IRS and requires the filing of a return for the short period (¶ 1505). To request IRS approval to change, Form 1128 generally must be filed by the due date of the taxpayer's return (not including extensions) for the first effective year. A change in the accounting period will be approved where it is established that a substantial business purpose exists for making the change but generally will not be approved where the sole purpose of the change is to maintain or obtain a preferential tax status (Reg. § 1.442-1(b)).<sup>23</sup> The IRS will consider all the facts and circumstances relating to the change, including the tax consequences. Among the non-tax factors is the effect of the change on the taxpayer's annual cycle of business activity. The agreement between the taxpayer and the IRS under which the change is carried out will, in appropriate cases, provide terms, conditions, and adjustments necessary to prevent a substantial distortion of income that would otherwise result from the change. For example, effects that would constitute substantial distortions of income include:

- (1) deferring a substantial portion of the taxpayer's income or shifting a substantial portion of deductions from one year to another so as to reduce substantially the taxpayer's tax liability;
- (2) causing a similar deferral or shift in the case of any other person, such as a partner, a beneficiary, or an S corporation shareholder; or
- (3) creating a short period in which there is either: (a) a substantial net operating loss, capital loss or credit (including a general business credit); or (b) a substantial amount of income to offset an expiring net operating loss, capital loss, or credit (Reg. § 1.442-1(b)(3)).<sup>24</sup>

**Non-individual Taxpayers.** Automatic approval procedures are provided for certain corporations that have not requested a tax year change within the most recent 48-month period ending with the last month of the requested tax year (Rev. Proc. 2006-45, modified by Rev. Proc. 2007-64). Automatic approval procedures are also provided for trusts and certain partnerships, S corporations, electing S corporations, and personal service corporations that have not requested a tax year change within the most recent 48-month period ending with the last month of the requested tax year, that meet certain conditions (Rev. Proc. 2006-46). If the automatic approval procedures do not apply, the IRS has provided other procedures for taxpayers to follow in order to obtain the IRS's prior approval of an adoption, change, or retention in an annual accounting period through application to the IRS national office (Reg. § 1.442-1(b)(3); Rev. Proc. 2002-39, modified by Rev. Proc. 2003-34 and Rev. Proc. 2003-79).<sup>25</sup>

**Individuals.** Certain individuals may also follow automatic approval procedures (Reg. § 1.442-1(b)(3); Rev. Proc. 2003-62). The only individual who may change his or her tax year without IRS consent is a newly married individual who is adopting the annual accounting period of his or her spouse to file a joint return (Reg. § 1.442-1(d)).<sup>26</sup>

**Improper Tax Year.** As an alternative to the above procedures, any taxpayer may correct a prior adoption of an improper tax year by filing Form 1128 with an amended return on a calendar year basis (Rev. Proc. 85-15).<sup>27</sup>

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>23</sup> ¶ 20,401, ¶ 20,406.41; ACCTNG: 24,200; § 38,120.05; § 38,101

<sup>24</sup> ¶ 20,401; ACCTNG: 24,200; § 38,120.20, § 38,125.10, § 38,130.25

<sup>25</sup> ¶ 20,401; ACCTNG: 24,200; § 38,120.05, § 38,125.05, § 38,130.05

<sup>26</sup> ¶ 20,401; ACCTNG: 24,152; § 38,110

<sup>27</sup> ¶ 20,406.15; ACCTNG: 24,166; § 38,110

## Chapter 23

### SPECIAL CORPORATE STATUS

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#### Mutual Funds

**2301. Qualification as a Mutual Fund.** Mutual funds (regulated investment companies) are domestic corporations that act as investment agents for their shareholders, typically investing in corporate and government securities and distributing income earned from the investments as dividends. Mutual funds may escape corporate taxation because, unlike ordinary corporations, they are entitled to claim a deduction for dividends paid to shareholders against their ordinary income and net capital gain. A corporation qualifies as a mutual fund if it makes an irrevocable election to be treated as such by filing a tax return on Form 1120-RIC, and it meets all of the following requirements (Code Sec. 851):<sup>1</sup>

- The corporation must be registered under the Investment Company Act of 1940 as a management company, unit investment trust, business development company, or as a type of common trust fund.

- At least 90 percent of its gross income must be derived from dividends, interest, payments with respect to certain securities loans, gains from the sale or disposition of stock or securities, or other income derived from the business of investing, including the net investment income of qualified publicly traded partnerships.

- At the close of each quarter of the tax year, at least 50 percent of its total assets must be invested in cash, government securities, securities of other mutual funds, or the securities of other issuers (so long as the securities of any given issuer do not exceed five percent of the value of the mutual fund's assets or 10 percent of the issuer's outstanding voting securities).

- At the close of each quarter of the tax year, no more than 25 percent of the total value of its assets may be invested in the securities of any one issuer (other than government securities or securities of other mutual funds), the securities of two or more issuers controlled by the mutual fund and engaged in a related trade or business, or the securities of one or more qualified publicly traded partnerships.

- The corporation must distribute at least 90 percent of its annual investment company taxable income (¶ 2303) and its net tax-exempt interest income (¶ 2307) to its shareholders (there is no threshold for net capital gains) (Code Sec. 852(a)).<sup>2</sup>

**2303. Taxation of Mutual Funds.** A mutual fund (regulated investment company) is subject to taxation at regular corporate income tax rates on its "investment company taxable income" (Code Sec. 852(b); Reg. § 1.852-3).<sup>3</sup> Investment company taxable income is computed on Form 1120-RIC in the same manner as the taxable income of an ordinary corporation (¶ 221) with the following adjustments:

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>1</sup> ¶ 26,400; RIC: 3,000, RIC: 3,050; § 19,201, § 45,430.05

<sup>2</sup> ¶ 26,420; RIC: 3,060; § 19,201, § 45,430.05

<sup>3</sup> ¶ 26,420, ¶ 26,424; RIC: 3,200; § 19,201, § 45,430.05

- gross income is the fund's ordinary income (net capital gains are not included);
- a deduction is allowed for any ordinary dividends paid (however, no deduction is allowed for dividends of capital gains or tax-exempt interest);
- no deduction is allowed for dividends received;
- no deduction is allowed for net operating losses (NOLs);
- taxable income of a short tax year is not annualized;
- if the fund so elects, taxable income is computed by disregarding the short-term discount obligation rules of Code Sec. 454(b); and
- a deduction is allowed for the tax imposed on the fund if it fails to meet the asset test or gross income test (¶ 2301).

For purposes of the dividends-paid deduction, dividends declared and payable by a mutual fund in October, November or December in a calendar year are treated as paid on December 31 of that year even if they are actually paid in January of the following calendar year (Code Sec. 852(b)(7)). In addition, a mutual fund may declare and pay "spillover dividends" after the close of a tax year that are considered made out of a mutual fund's earnings and profits for that year. Spillover dividends are also included in the calculation of mutual fund taxable income for that year and are considered in determining whether the mutual fund met its distribution requirements for the year. Spillover dividends in tax years beginning after December 22, 2010, must be declared no later than the fifteenth day of the ninth month following the close of the tax year to which the dividend relates, or the extended due date for the mutual fund's return for the tax year, whichever comes later. The dividend must be paid no later than the date of the first dividend payment of the same type of dividend (e.g., capital gains or ordinary) after the declaration, but no later than 12 months after the close of the tax year to which the dividend relates (Code Sec. 855(a)).<sup>4</sup>

On the other hand, a mutual fund, other than a publicly traded mutual fund, generally may not claim a deduction for dividend distributions if it singles out one class of shareholders, or one or more members of a class of shareholders, for special dividend treatment, unless such treatment was originally intended when the dividend rights were created (Code Sec. 562(c); Rev. Rul. 89-81).<sup>5</sup> However, the IRS has issued guidance describing the conditions under which distributions to mutual fund shareholders may vary and nevertheless be deductible, including the treatment of distributions to shareholders that differ as a result of the allocation and payment of fees and expenses (Rev. Proc. 99-40).<sup>6</sup>

**Excise Taxes.** A nondeductible excise tax is generally imposed on a mutual fund that does not satisfy minimum distribution requirements (Code Sec. 4982).<sup>7</sup> The tax is four percent of the excess of any "required distribution" for the calendar year over the amount actually distributed for the calendar year. For this purpose, the required distribution is the sum of 98 percent of the fund's ordinary income for the year, plus 98.2 percent of its net capital gain income for the one-year period ending October 31 of the calendar year. (For calendar years before 2011, both amounts were 98 percent.) Special rules apply in how a mutual fund treats post-October 31 capital gains and foreign currency losses. For excise tax purposes, amendments made in 2010 to the capital loss carryover rules (¶ 2305) apply beginning with any net capital loss recognized in the period that determines a mutual fund's required distribution for calendar year 2011 (Rev. Rul. 2012-29).<sup>8</sup>

**2305. Capital Gains and Losses of Mutual Funds.** A mutual fund (regulated investment company) may avoid corporate level tax on its net capital gains by distribut-

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>4</sup> ¶ 26,420, ¶ 26,480; RIC: 3,450; § 19,205.05

<sup>6</sup> ¶ 26,433.28; RIC: 3,204.10; § 26,905.15

<sup>8</sup> ¶ 34,642.10; RIC: 3,212; § 19,201, § 45,430.05

<sup>5</sup> ¶ 23,470, ¶ 26,433.50; RIC: 3,204.10; § 26,905.15

<sup>7</sup> ¶ 34,640; RIC: 3,212; § 19,201, § 45,430.05

ing such gains to shareholders. However, if the mutual fund elects to retain some of its net capital gains, then it is subject to tax at regular capital gains rates on the excess of its net capital gains for the tax year over the amount of any capital gains dividends paid during the year (Code Sec. 852(b)(3)).<sup>9</sup> Form 2438 is used to figure and report the fund's capital gains. Although the fund is taxed on its undistributed net capital gains, it may elect to designate to its shareholders some or all of its undistributed gains and the tax paid on those gains. Form 2439 is used to notify each shareholder of his or her portion of the undistributed capital gains and tax paid for the year (§ 2309 and § 2311).

**Capital Loss Carryovers.** For tax years beginning after December 22, 2010, if a mutual fund has a net capital loss for a tax year, any excess of the net short-term capital loss over the net long-term capital gain is treated as a short-term capital loss arising on the first day of the next tax year, and any excess of the net long-term capital loss over the net short-term capital gain is treated as a long-term capital loss arising on the first day of the next tax year (Code Sec. 1212(a)(3)(A)).<sup>10</sup> There is no limit to the number of tax years that a net capital loss of a mutual fund may be carried over. However, for tax years beginning before December 23, 2010, a mutual fund can carry net capital losses forward only for eight years, and losses carried forward are treated as short-term capital losses in the year of use (Code Sec. 1212(a)(1)(C), prior to amendment by the Regulated Investment Company Modernization Act of 2010 (P.L. 111-325)).

If a net capital loss under the general corporate capital loss carryback and carryover rules (§ 1756) is carried over to a tax year of a mutual fund, amounts treated as a long-term or short-term capital loss arising on the first day of the next tax year under the capital loss carryover rules for mutual funds (discussed above) are determined without regard to amounts treated as a short-term capital loss under the general corporate capital loss carryover rule. Further, in determining the reduction of a carryover by capital gain net income for a prior tax year under the general corporate capital loss carryover rule, any capital loss treated as arising on the first day of the prior tax year under the capital loss carryover rules for mutual funds is taken into account in determining capital gain net income for the prior year (Code Sec. 1212(a)(3)(B)).<sup>11</sup> Capital gain net income is the excess of gains from the sale or exchange of capital assets over losses from such sales or exchanges (Code Sec. 1222(9)).<sup>12</sup>

**2307. Tax-Exempt Interest of Mutual Funds.** A mutual fund (regulated investment company) may pay tax-exempt interest earned on state or local bonds to its shareholders in the form of exempt-interest dividends, but only if the bonds represent at least 50 percent of the value of the fund's assets at the close of each quarter of its tax year (Code Sec. 852(b)(5)).<sup>13</sup> Form 1099-INT is used to inform shareholders of dividends identified as tax-exempt interest dividends (§ 2309 and § 2311).

An upper-tier mutual fund that is a qualified fund of funds may pass through exempt-interest dividends and foreign tax credits to its shareholders, without having to meet the 50-percent asset requirement (Code Sec. 852(g)).<sup>14</sup> A qualified fund of funds is a mutual fund if, at the close of each quarter of the tax year, at least 50 percent of the value of its total assets is represented by interests in other mutual funds.

Generally, if a mutual fund shareholder receives an exempt-interest dividend with respect to any share held for six months or less, then any loss on the sale or exchange of such share is disallowed to the extent of the amount of the exempt-interest dividend (Code Sec. 852(b)(4)).<sup>15</sup> However, for losses incurred on shares of stock for which the taxpayer's holding period begins after December 22, 2010, the disallowance of a loss on the sale or exchange of mutual fund shares, on which exempt-interest dividends have been paid, does not apply, except as otherwise provided by regulations, to a regular

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>9</sup> § 26,420; RIC: 3,250; § 19,205.05, § 45,430.10

<sup>10</sup> § 30,400; RIC: 3,252; § 16,535

<sup>11</sup> § 30,400; RIC: 3,252; § 16,535

<sup>12</sup> § 30,440; SALES: 15,202.45; § 16,530

<sup>13</sup> § 26,420; RIC: 3,300; § 19,205.05, § 45,430.10

<sup>14</sup> § 26,420; RIC: 3,300; § 19,205.35

<sup>15</sup> § 26,420; RIC: 3,258; § 19,230.15

dividend paid by a mutual fund which declares exempt-interest dividends on a daily basis in an amount not less than 90 percent of its net tax-exempt interest and distributes such dividends on a monthly or more frequent basis.

**2309. Designation of Mutual Fund Distributions.** A mutual fund (regulated investment company) must report in written statements furnished to its shareholders the portions of distributions made during the tax year which are capital gains dividends (§ 2305) and exempt-interest dividends (§ 2307), as well as any foreign tax credits (§ 2320), tax credit bond credits (§ 2320), dividends that qualify for the dividends-received deduction (§ 223), and passed-through ordinary dividends eligible for the reduced tax rate for qualified dividends (§ 2311) (Code Secs. 852(b)(3)(C) and (5), 853(c), 853A(c), and 854(b)).<sup>16</sup> Capital gain dividends, and dividends received from a tax-exempt corporation, and dividends received from a qualified real estate investment trust (REIT) (§ 2326) are not eligible for the dividends-received deduction (Code Sec. 854(a) and (b)(2)). The aggregate amount which the mutual fund can report as dividends eligible for the dividends-received deduction is limited to its aggregate dividends received from domestic corporations for the tax year. The aggregate amount which the mutual fund can report as qualified dividend income is limited to its qualified dividend income for the tax year (Code Sec. 854(b)(1)(C)).

Additionally, within 60 days after the close of its tax year, a mutual fund must report and notify its shareholders of the portion of distributions made during the tax year that is designated as undistributed capital gain (Code Sec. 852(b)(3)(D)).

**2311. Taxation of Mutual Fund Distributions.** The tax treatment of a distribution received from a mutual fund (regulated investment company) depends on how the distribution is designated (§ 2309). Distributions not designated as capital gain dividends are generally treated by shareholders as ordinary income to the extent of the fund's earnings and profits. However, all or a portion of the distribution may be a qualified dividend eligible to be taxed at capital gains rates (§ 733), if the aggregate amount of qualified dividends received by the fund during the year is less than 95 percent of its gross income (Code Sec. 854(b)(1)(B)).<sup>17</sup> Distributions reported as tax-exempt interest dividends may generally be excluded from the shareholder's gross income (Code Sec. 852(b)(5)(B)).<sup>18</sup> However, exempt-interest dividends derived from private activity bonds constitute tax preference items for alternative minimum tax (AMT) purposes (§ 1425).

**Comment:** Absent further legislation, ordinary income tax rates will apply to qualified dividend income (§ 733) that is passed through a mutual fund after December 31, 2012.

Distributions received from a mutual fund reported as capital gain dividends may be treated as long-term capital gains by the shareholder for income and AMT purposes, regardless of how long the shareholder held the shares (Code Sec. 852(b)(3)(B)).<sup>19</sup> Similarly, capital gains that the fund elects to pass through to the shareholder are treated as long-term capital gains (§ 2305). The shareholder is entitled to a credit or refund for its portion of any capital gain taxes paid by the mutual fund on the undistributed capital gains (Code Sec. 852(b)(3)(D)). In addition, the shareholder may increase the basis of its mutual fund shares by the difference between the undistributed capital gains and its deemed portion of taxes paid. The mutual fund must designate distributions as undistributed capital gain dividends, reporting the designation and providing shareholders a written notice within 60 days of the end of its tax year (§ 2309).

If a shareholder receives a capital gain dividend or has capital gain passed through by the fund with respect to any share or beneficial interest, and holds the share for six months or less, then any loss on the sale of that share is treated as a long-term capital

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>16</sup> § 26,420, § 26,440, § 26,448, § 26,460; RIC: 3,400; § 19,205.05, § 45,430.10

<sup>17</sup> § 26,460; RIC: 3,400; § 19,205.10, § 19,205.15

<sup>18</sup> § 26,420; RIC: 3,300; § 19,205.35

<sup>19</sup> § 26,420; RIC: 3,250; § 19,205.20, § 19,205.25

loss to the extent of any long-term capital gain (Code Sec. 852(b)(4)).<sup>20</sup> In addition, the amount of loss that may be claimed must also be reduced by the amount of any exempt interest dividend received on the shares. These rules do not apply to losses incurred on the disposition of mutual fund shares or beneficial interest pursuant to a plan that provides for the periodic liquidation of such shares or interests. For purposes of determining whether a taxpayer has held mutual fund shares for six months or less, rules similar to those for the dividends-received deduction are applied (§ 223).

A mutual fund shareholder may also not claim a loss from the sale or exchange of mutual fund shares if the wash sale rules apply (§ 1935).

A distribution that is not out of a mutual fund's earnings and profits is a return of the shareholder's investment. Return-of-capital distributions are generally not subject to tax, and they reduce the shareholder's basis in the mutual fund shares. On the other hand, mutual fund distributions that are automatically reinvested by the shareholder into more shares of the fund must be taxed as if they had actually been received by shareholder in cash. Thus, reinvested ordinary dividends and reinvested capital gain distributions are generally taxed as income, reinvested exempt-interest dividends are not reported as income, and reinvested return-of-capital distributions are reported as a return of capital (IRS Pub. 550).

**2313. Earnings and Profits of Mutual Funds.** Dividends from a mutual fund (regulated investment company), just like dividends from most other corporations, must be paid out of earnings and profits (§ 747—§ 757) (Code Secs. 301, 312, 316, 561, 562(a), and 852(a)(1)).<sup>21</sup> Thus, a mutual fund must be careful to maintain sufficient current or accumulated earnings and profits to satisfy annual dividend distribution requirements. There should also be enough earnings and profits to avoid the excise tax on the undistributed income of a mutual fund (§ 2303).

A mutual fund's earnings and profits are generally computed under the rules that apply to ordinary corporations. However, mutual funds do not reduce their current earnings and profits by any amount they are unable to claim as a deduction from taxable income in that year (Code Sec. 852(c)(1)).<sup>22</sup> For tax years beginning after December 22, 2010, net capital loss for a tax year is not taken into account in determining earnings and profits; however, any capital loss treated as arising on the first day of the following tax year is taken into account in determining earnings and profits for that year (subject to the application of the net capital loss rule for that year). Also, in tax years beginning after December 22, 2010, deductions disallowed in computing mutual fund taxable income with respect to tax-exempt interest are allowed in calculating a mutual fund's current earnings and profits (but not accumulated earnings and profits).

Effective for distributions made in tax years beginning after December 22, 2010, if a mutual fund that is not a calendar-year taxpayer makes distributions to its shareholders with respect to any class of stock of the company in excess of the sum of its current and accumulated earnings and profits (i.e., a portion of the distribution constitutes return of capital or capital gain), its current earnings and profits must be allocated first to distributions during the mutual fund's tax year that are made before January 1 (Code Sec. 316(b)(4)).<sup>23</sup> If a mutual fund has more than one class of stock, this rule applies separately to each class of stock, so that distributions made during the corporation's tax year are considered to be made to the shares with higher priority before they are made to shares with lower priority (Rev. Rul. 69-440).<sup>24</sup>

A company that has failed to qualify as a mutual fund because it has not purged itself of non-mutual fund earnings and profits may still qualify if it distributes those earnings and profits with interest to its shareholders (Code Sec. 852(e)).<sup>25</sup> In order to

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>20</sup> § 26,420; RIC: 3,258;  
§ 19,210.05

<sup>22</sup> § 26,420; RIC: 3,204.15;  
§ 19,201

<sup>24</sup> § 15,704.755; CCORP:  
12,166; RIC: 3,204.15; § 26,601

<sup>21</sup> § 15,302; § 15,600; § 15,702;  
§ 23,450; § 23,470; § 26,420; RIC:  
3,204.15; § 26,201

<sup>23</sup> § 15,702; RIC: 3,204.15;  
§ 26,601

<sup>25</sup> § 26,420; RIC: 3,202

qualify, distributions must be specifically designated as non-mutual fund distributions and take place within the 90-day period that begins on the date the corporation is determined not to be a mutual fund (§ 2317). This option is not available if the corporation was determined not to be a mutual fund because it engaged in fraudulent tax evasion.

**2315. Redemption of Mutual Fund Shares.** Generally, a redemption of stock by a corporation, including a mutual fund (regulated investment company), is treated as an exchange of stock if the redemption falls within one of four categories of transactions (Code Sec. 302):<sup>26</sup> (1) a redemption that is not essentially equivalent to a dividend; (2) a substantially disproportionate redemption; (3) a redemption that terminates the shareholder's interest in the corporation; or (4) a partial liquidation, in the case of a noncorporate shareholder. Redemptions of corporate stock are discussed in § 742—§ 745. Because transactions that fall within one of these four categories are treated as exchanges of stock, they normally result in capital gain treatment to the redeemed shareholder. If the redemption does not fall within any of these categories, it is treated as a Code Sec. 301 distribution of property that generally results in dividend treatment.

Special rules apply to redemptions of mutual fund shares. Effective for distributions after December 22, 2010, a distribution in redemption of stock of a publicly offered mutual fund is treated as an exchange for stock if the redemption is upon the demand by the stockholder, and the mutual fund issues only stock that is redeemable upon the demand of the stockholder. A publicly offered mutual fund is a fund whose shares are (1) continuously offered pursuant to a public offering; (2) regularly traded on an established securities market; or (3) held by or for no fewer than 500 persons at all times during the tax year (Code Sec. 67(c)(2)(B)).<sup>27</sup> Additionally, the loss disallowance and deferral rules for transactions between related persons (§ 1717) do not apply to any redemption of stock of a fund-of-funds mutual fund if the mutual fund issues only stock that is redeemable upon the demand of the stockholder and the redemption is upon the demand of another mutual fund (Code Sec. 267(f)(3)(D)).<sup>28</sup>

**2317. Deficiency Dividends of Mutual Funds.** If there is a determination that adjustments are needed to certain amounts that a mutual fund (regulated investment company) reports for a tax year, and if the adjustments could cause the entity to lose its mutual fund status, the mutual fund may avoid disqualification by making deficiency dividend distributions, and may claim a deduction for such dividends paid (Code Sec. 860; Reg. §§ 1.860-1—1.860-5).<sup>29</sup> A deficiency dividend is a distribution of property (including money) that would have been includible in calculating the entity's dividends-paid deduction had the property been distributed during the tax year. The distribution must be made within 90 days after the determination date, and before the entity files a deficiency dividend deduction claim, which must be filed on Form 976 within 120 days after the determination date.

For a mutual fund, an adjustment can be (1) an increase in its investment company taxable income, determined without regard to the dividends-paid deduction; (2) an increase in the amount of the excess of its net capital gain over its deduction for capital gain dividends paid; or (3) a decrease in its dividends-paid deduction (determined without regard to capital gains dividends). A determination is a final decision by a court, a closing agreement, an agreement between the IRS and the entity relating to its tax liability, or a statement by the entity attached to its amendment or supplement to a tax return for the relevant tax year. Filing Form 8927 is treated as a "self-determination" by the entity for these purposes (Rev. Proc. 2009-28).<sup>30</sup>

The deficiency dividend deduction is not available if part of the adjustment is due to fraud with intent to evade tax or willful failure to file a timely income tax return.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

<sup>26</sup> § 15,325; CCORP: 21,104;  
§ 26,301

<sup>28</sup> § 14,150; CCORP: 21,100;  
SALES: 39,112.05; § 19,210.07

<sup>30</sup> § 42,625.435; RIC: 3,500

<sup>27</sup> § 6060; RIC: 3,204.10;  
§ 19,210.07

<sup>29</sup> § 26,580; § 26,581—§ 26,585;  
RIC: 3,500