INVESTMENT COMPANY INSTITUTE

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IRS PAPER REGARDING TREATMENT OF EXPENSES OF ORGANIZING FUNDS

April 15, 1991 TO: TAX COMMITTEE NO. 10-91 MEMBERS - ONE PER COMPLEX NO. 16-91 RE: IRS PAPER REGARDING TREATMENT OF EXPENSES OF ORGANIZING FUNDS ____ Currently the Internal Revenue Service is auditing the tax returns of several mutual fund investment advisers. As a result of these audits, the IRS has proposed making the tax treatment of costs incurred by investment advisers in creating new mutual funds a "coordinated issue". Attached is a copy of the proposed coordinated issue paper. A "coordinated issue" is one in which the Service develops a uniform position on a matter which potentially affects an en- tire industry. Taxpayers in that industry may then be targeted with respect to the coordinated issue, and the Service generally applies the conclusions of the coordinated issue paper to all such taxpayers. In an audit, an IRS agent cannot settle a coordinated issue on terms which differ from the coordinated is- sue paper without express permission from the IRS industry spe- cialist responsible for the issue. The proposed coordinated issue is whether expenses incurred by investment advisers in forming new mutual funds and obtaining the investment management contracts for those funds can be deducted in the year paid as an expense under Internal Revenue Code section 162(a), or whether these amounts should be capitalized under Code section 263 and amortized over a period of years. Generally, expenditures are capitalized if they serve to create or enhance a separate and distinct asset with a useful life extending beyond one year. As you know, the expenses incurred by the investment adviser in forming a new fund typically are treated as ordinary and necessary business expenses to the extent not allocated to the fund. The IRS claims that the management contract is an asset and that the expenses of organizing the fund and obtaining the management contract must be amortized over the useful life of the asset. However, because the IRS is contending that management contracts have an indefinite life, the paper concludes that the expenses of obtaining this asset are nonamortizable. Because the Internal Revenue Service National Office must approve any coordinated issue proposal, this paper has been submitted to the National Office. In addition, the affected industry is generally given the opportunity to respond to the proposed coordinated issue paper. The Institute is currently developing a response. We will keep you informed of developments. Catherine L. Heron Vice President - Tax and Pension Attachment