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United States. Securities and Exchange Commission

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FOR RELEASE Wednesday, December 31, 1969

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

INVESTMENT COMPANY ACT OF 1940
Release No. 5943
SECURITIES ACT OF 1933
Release No. 5035
SECURITIES EXCHANGE ACT OF 1934
Release No. 8788
ACCOUNTING SERIES
Release No. 114

ADOPTION OF AMENDMENTS TO RULE 6-02-9 OF
ARTICLE 6 OF REGULATION S-X AND RULE 2a-4
UNDER THE INVESTMENT COMPANY ACT OF 1940
WITH RESPECT TO PROVISION BY REGISTERED
INVESTMENT COMPANIES FOR FEDERAL INCOME TAXES

On August 20, 1969, the Securities and Exchange Commission published notice (Investment Company Act Release No. 5780) that it had under consideration the amendment of Rule 6-02-9 of Article 6 of Regulation S-X and a related amendment of Rule 2a-4 under the Investment Company Act of 1940 ("Act").

Article 6 of Regulation S-X governs the form and content of financial statements filed by management investment companies (other than those which are issuers of periodic payment plan certificates) under the Act, the Securities Act of 1933 and the Securities Exchange Act of 1934. Rule 6-02-9 of Article 6 requires that appropriate provision shall be made in the financial statements of such companies for Federal income taxes.

Rule 2a-4 under the Act defines the term "current net asset value" of redeemable securities issued by registered investment companies used in computing periodically the current price of such securities for the purpose of distribution, redemption, and repurchase. Subparagraph (a)(4) of Rule 2a-4 provides that in computing such current net asset value expenses shall be included to the date of calculation.

The proposed amendment of Rule 6-02-9 of Regulation S-X would specifically provide that a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with Section 852(b)(3)(D) of the Internal Revenue Code ("Code") shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains realized during such year. The amendment would also revise the reference in Rule 6-02-9 to the section of the Code defining a company's status as a "regulated investment company" to its present designation of Subtitle A, Chapter 1, Subchapter M. The proposed amendment of Rule 2a-4 under the Act would add a sentence to subparagraph (a)(4) to require that appropriate provision shall be made for Federal income taxes in accordance with Rule 6-02-9 of Regulation S-X.

The primary purpose of the proposed amendment is to assure that regulated investment companies excepted by provisions of the Code from payment of Federal income taxes on net income and realized gains distributed to shareholders will make appropriate provision for taxes on any realized undistributed capital gains designated as distributions to shareholders under the provisions of the Code. Most regulated investment companies follow the practice of distributing realized capital gains to shareholders, thereby relieving such companies of the payment of Federal income taxes on such gains. However, under the provisions of Section

852(b)(3)(D) of the Code, a regulated investment company which elects to do so may retain realized long-term capital gains and, in effect, pay the tax on those gains on behalf of the shareholders. Every such shareholder at the close of the company's taxable year shall include in his tax return his pro rata portion of the company's realized capital gains as if it had been distributed to him, accrue his capital gains tax thereon, and elsewhere in his tax return is allowed credit or refund for his pro rata share of the capital gains tax which has been paid for his benefit by the company but which is deemed to have been paid by him. At the same time, such shareholder shall increase the tax basis of his shares by the excess of his pro rata portion of the realized gains over the tax credit or refund allowed to him.

The question of the appropriate method of tax accrual or adjustment of net asset value by investment companies which retain realized capital gains under Section 852(b)(3)(D) of the Code was considered by the National Association of Investment Companies (the predecessor to the present Investment Company Institute) and the Committee on Relations with the S.E.C. of the American Institute of Accountants in 1956 following the enactment of the provisions of the Code in its present form. On November 2, 1956, the Association send a memorandum to its members stating in part that the question had been considered by the Committee which was of the opinion that, since for a company intending to proceed under Section 852(b)(3)(D) the tax on realized undistributed capital gains would be on the shareholder and not the company, no allowance need be made, either for possible Federal income tax on unrealized appreciation or for Federal income tax on capital gains realized during the year. The memorandum stated that at the end of a company's taxable year the Federal income tax to be paid on realized but undistributed capital gains would be carried in an accrual account until paid.

The above procedure is followed as the generally accepted accounting practice by regulated investment companies which elect to retain realized capital gains and pay the tax on behalf of shareholders. Most of such companies are capital exchange funds which issued their shares for securities in tax-free exchanges and which are not making public offerings of shares. Of a total 34 active exchange funds, 30 elected for their fiscal years ended in 1968 to retain realized capital gains, in whole or in part, and pay the tax on behalf of the shareholders. All except four of these exchange funds followed the practice of making provision for such taxes on the last day of the taxable year. The four funds which did not follow the general practice, made provision for taxes on realized undistributed capital gains throughout the year as the gains were realized.

The proposed amendments to the rules would codify the generally accepted practice of making provision, on the last day of the taxable year of the investment company, for taxes on realized undistributed capital gains designated as distributions to shareholders. The amended rules would not affect the rights of any person who may have redeemed shares prior to the adoption of the amendments.

Under the provisions of the Code, the taxes on realized capital gains retained by the company are payable by the company only on behalf of those persons who are shareholders on the last day of the taxable year in which the gains were realized. It is only those persons who are shareholders on the last day of the taxable year who are deemed under the provisions of the Code to have paid the tax imposed on the designated capital gains retained by the company and who, accordingly, are allowed credit or refund for the tax so deemed to have been paid by them and are entitled to increase the tax basis of their shares by the excess of their pro rata portion of the realized gains over the tax credit or refund allowed to them. Accrual of the tax by the company at any time

prior to the last day of its taxable year therefore reduces the net asset value of the shares of holders who redeem or sell their shares during the year and who consequently receive no credit for the tax so accrued.

After consideration of the comments and suggestions received from interested persons, the Commission has determined to adopt the amendments to the rules.

The amendment of Rule 6-02-9 of Article 6 of Regulation S-X is adopted pursuant to Sections 8, 30, 31(c) and 38(a) of the Investment Company Act of 1940; Sections 7 and 19(a) of the Securities Act of 1933; and Sections 12, 13, 15(d), and 23(a) of the Securities Exchange Act of 1934. The proposed amendment of Rule 2a-4 under the Investment Company Act of 1940 is adopted pursuant to Sections 22 and 38(a) of that Act.

The rules as amended are set forth below. The language added to the present rules is underlined, and the language deleted is in brackets.

Rule 6-02-9 of Article 6 of Regulation S-X is amended to read as follows:

9. Federal income taxes. -- Appropriate provision shall be made, on the basis of the applicable tax laws, for Federal income taxes that it is reasonably believed are, or will become, payable in respect of (a) current net income, (b) realized gain on investments and (c) unrealized appreciation on investments. The company's status as a "regulated investment company" as defined in [Supplement Q*] Subtitle A, Chapter 1, Subchapter M of the Internal Revenue Code as amended shall be stated in a note referred to in the appropriate statements. Such note shall also indicate briefly the principal present assumptions on which the company has relied in making or not making provisions for such taxes. However, a company which retains realized capital gains and designates such gains as a distribution to shareholders in accordance with Section 852(b)(3)(D) of the Code shall, on the last day of its taxable year (and not earlier), make provision for taxes on such undistributed capital gains during such year.

Subparagraph (a)(4) of Rule 2a-4 under the Investment Company Act of 1940 is amended so that paragraph (a) and subparagraph (a)(4) read as follows:

(a) The current net asset value of any redeemable security issued by a registered investment company used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects calculations, whether or not recorded on the books of account, made substantially in accordance with the following, with estimates used where necessary or appropriate:

* * * * *

(4) Expenses, including any investment advisory fees, shall be included to date of calculation. Appropriate provision shall be made for Federal income taxes in accordance with Rule 6-02-9 of Regulation S-X.

* * * * *

The amendments to Rule 6-02-9 of Article 6 of Regulation S-X and Rule 2a-4 under the Act shall be effective so that after the date of adoption of the amendments (December 31, 1969) no further provision shall be made for taxes in the circumstances stated in the amendment to Rule 6-02-9 except on the last day of the taxable year.

By the Commission.

Orval L. DuBois
Secretary



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