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# The Investment Club - Beware!

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Of what should the investment club beware? From the growing popularity of investment clubs, it would appear that many people feel there is no real alarm. The latest information available states that over 7,700 clubs comprising some 102,000 members belong to the National Association of Investment Clubs. NAIC was formed in October 1951 with four Detroit clubs as members, indicating the growth in just over ten years. New York Stock Exchange studies estimate that NAIC clubs make up only about one fifth of all U. S. investment clubs. This would indicate about 500,000 members of investment clubs with club portfolios of $10 million of stock purchases each month and total holdings of about a half billion dollars.

The increase in the number has brought investment clubs to the attention of a great many agencies including the various taxing authorities, State and Federal regulatory agencies, stock transfer agents and other interested parties. Thus, it is necessary that each club be informed and comply with any Federal, State or Local regulations which may pertain to the organization and operation of the club. Consulting an attorney for guidance is advisable.

Taxwise perhaps the only question is Corporation or Partnership? Which is better for an investment club and the members of the club? The position of the Internal Revenue Service with regard to the tax status of investment clubs will enter into this decision.

In December of 1960 the Treasury Department issued a permanent tax ruling citing the provisions which would determine the Federal income tax status of an investment club. The Treasury ruling stated that six tests were used to determine if an organization was to be taxed as a corporation. If a club met four or more of the tests, it would be taxed as a corporation, if not, then it would be taxed as a partnership. These were the six tests:

1. The existence of a group of associates.
2. A common objective to carry on a business and divide the gains therefrom.
3. Continuity of life.
4. Centralization of management.
5. Liability for corporate debts limited to corporate property.
6. Free transferability of interests.

In its published ruling, the Treasury Department indicates investment clubs may have the first two characteristics, but do not necessarily have the last four and consequently are taxable as partnerships. However, the application of these tests to a particular club should be discussed with an attorney.

An investment club is a group of associates and the natural objective of such a group is to carry on a business, earn dividends and realize gains from the sale of stocks and securities, and divide the gains therefrom. Perhaps this division of profits will not be made annually, but it will be made eventually, and no one in an investment club has thoughts of not making money even though monetary education may be another of the aims.

Test 3—Continuity of life. While some clubs have not set a date or time when they will liquidate, others have and this may be 2, 5 or 10 years from the date of organization. Thus the answer to this test depends on each individual club.

Test 4—Centralization of management. Do a few members, perhaps the officers or board determine which stock will be purchased or sold and generally manage or run the club or do all the members of the club have a voice in this management with a majority rule type of operation? Again the answer depends on the club.

Test 5—Liability for corporate debts limited to corporate property. A partner is responsible for the acts of the partnership and the other members of said partnership. One investment club in discussing this test with their attorney found that while the members were liable for any act of their partnership it did not mean that they would be liable for the personal acts or debts of members of the partnership outside the partnership. Since most clubs are limited in nature and consist of individuals well known to one another and do not buy on margin or borrow money to operate the club, it would appear that the chance of incurring a large or unusual liability in the operation of the club is very unlikely. Therefore the question of liability should not be the prime decision as to whether an investment club should be a corporation or partnership. It is advisable, however, to carry a fidelity bond on the club members as a precaution against misappropriation of club assets.

Test 6—Free transferability of interest. Does the agreement under which the club op-

erates allow one member to transfer his interest to another as the shareholder of a corporation is able to do, or does this agreement state that such transfer of interest must have the approval of the other members of the club?

The foregoing is a quick review of the Treasury Department's tests for investment clubs, but how will the decision to operate as a corporation or partnership affect the personal fortunes of the club members?

At first glance there would appear to be a point in favor of the corporation when one recalls that dividends received by a corporation from another corporation are 85% tax free, thus only 15% of dividend income is taxable. Further the Internal Revenue Code permits $100,000 of earnings to be retained in a corporation without penalty. Since most clubs will have taxable earnings under $25,000 each year, their taxable dividends and interest will be taxed at 30% and their capital gains at 25%. The corporation pays all taxes and the members pay no tax until a distribution is made by the corporation to the club members. If no distribution is made, the corporation could eventually be liquidated and all of the earnings would become taxable to the members as capital gains rather than as ordinary income.

On the other hand, income to a partnership is taxable income to the partners. Partnerships file information return 1065 reporting the amount of ordinary income as well as capital gains or losses distributable to each partner. Each member partner reports his share of the partnership income and pays income tax on his prorata share whether the profits are withdrawn or left to be reinvested. If these earnings are left in the partnership and reinvested, the basis of each partner increases, while the basis for each member of a corporation investment club is only the amount the member has invested. Earnings do not increase his investment account but do increase his equity through surplus.

After a second look at the tax picture and a comparison of the end results, it will be realized that for most individuals the partnership method of taxation is the more favorable. Assume that the "income figures" in the following illustration are taxable income, after all deductions and personal exemptions. Each member of the investment club has sufficient personal stock holdings to have received more than $50 in dividends. Thus dividends earned through the investment club are wholely taxable. There are ten members, each in the 30% tax bracket. The club has dividend income of $1,000 and long term capital gains of $2,000. Under a partnership, each of the ten members will report $100 dividend income and $200 long term capital gain. The tax each member will pay, after deducting the dividend earned credit will be $56, the total for all ten members $560.

The corporation on the other hand will pay 30% tax on $150 dividends (after deducting the 85% dividends received deduction). Tax on dividends—$45. The corporation will also pay a 25% tax on the $2,000 of long term capital gains or $500. Thus the corporation tax is $540. or almost as much as the ten members combined will pay as partners. If we stopped at this point, there would be very little difference. However, most investment clubs do eventually liquidate, and upon dissolution the stockholders of a corporation will have a taxable long term capital gain. After deducting the $540 corporation income tax from the $3,000 income there is left $2,460 which when eventually taxed to the members of the corporation will result in $378 tax. Thus the combined taxes, first the corporation tax and later the capital gains tax upon dissolution, result in more than 160% of the tax the partners would pay under a partnership.

Using the same example but changing the partners tax bracket to 43% we find the tax for the ten partners is $820 while the combined corporate tax and capital gains tax upon liquidation is $1,081.80 or 132% of the tax if the club is taxed as a partnership. The break-even point is reached in this illustration when the partners are in the 69% tax bracket. The amount by which the combined corporate tax and capital gains tax exceeds the tax paid by partners will vary depending on the relationship between dividend income and capital gains. In this illustration no consideration was given to State Franchise taxes since these will vary from state to state. They are, however, another expense of the corporation. This example illustrates that for most individuals the partnership form is the better taxwise. However, when the members are in a comparatively high income tax bracket, it might be advantageous for the investment club to be taxed as a corporation.

If the members are certain that they want this status, it would be assured if they take the proper steps to incorporate under State law. Such a step, however, should not be taken without consideration of all the other factors which may be involved including SEC registration requirements, compliance with State Blue Sky laws, payment of State charter fees, as well as the franchise tax and the filing of periodical reports required by the State. If the club incorporates, there would

be a Federal stamp tax on issuance of any shares or certificates of stock.

If the partnership status is preferred, steps should be taken to insure this result. The wording of the club's operating agreement is important. It is advisable that the club use formal articles of copartnership with such adjustments, including provisions for contributions by the members, valuation of members' interest, management of the enterprise as well as any other points they may want to have covered. If this is not done, it is entirely possible for a club to defeat its intention of being taxed as a partnership and become an "accidental" corporation, even though it is not incorporated under State law. How can this happen? Centralized management in one or more of the members, limited liability, issuance of transferable shares, transferability of the shares without the consent of the other members, provision for continuity of existence after death or withdrawal of a member. All these attributes or operating provisions, when considered together, can make the club an association rather than a partnership under the six tests the Treasury Department used. The importance of the wording of the operating agreement cannot be stressed too much.

We have already discussed the income of an investment club and the manner in which it is reported. Now let us discuss the expenses which may be deducted. The following is a check list of deductible expenses which an investment club might incur.

State income tax
Alaska gross receipts tax
Personal property tax
Indiana gross income tax
New Mexico gross income tax (not on dividends)
Philadelphia school district tax
West Virginia gross Income Tax
Florida, New York and Texas stock transfer taxes
South Carolina stock and bond transfer taxes
Annual business tax (such as in Conn. and Florida)
Postage and stationery used in corresponding with a club's broker, or in obtaining information about investments which the club has under consideration, and (since this is where investment decisions are made) notices of meetings, account books, etc.
Safe deposit box rental
Compensation for services, such as typing or mimeographing
Premiums for liability bond
Bank charges for checking account
Telephone calls
Legal and accounting costs
Subscriptions to investment services
Rent, light and heat (if the club has separate quarters)

Since these items are income-producing expenses they may be paid out of the club's income and the net amount distributed to the members. There is another method which may be used. Once or twice a year, as needed, each member may be assessed $1 or more to cover any of these expenses. This assessment is kept in a separate account. Each year the members then report their full share of dividend as well as capital gains income and they may also take as a deduction their share of the club's expenses.

One point of particular interest is the ruling as to termination of a partnership, since continuity of life was one of the six tests the Treasury Department used. Internal Revenue Code—Sec. 708 reads

> (a) For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.
>
> (b) Termination—
>
> (1) General Rule—For purposes of subsection (a), a partnership shall be considered as terminated only if—
>
> (A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or
>
> (B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

In most cases the withdrawal of a member of an investment club will not terminate the partnership, providing the continuing members carry on the club (with or without a successor to replace the member who withdraws).

> Example. A member sells 30% interest and within one year another sells 25% interest. Partnership is terminated.
>
> A member sells 30% interest and subsequently the new member sells that same 30% interest—no liquidation since only 30% interest was sold.

If a partner dies or retires from the partnership, the retiring partner or the deceased partner's successor in interest (his estate or beneficiary) is regarded as a partner until his entire interest is liquidated.

Upon liquidation there is a difference in the amount of gain or loss to the members

depending on whether the club operated as a corporation or partnership. If the club was taxed as a corporation, the club member is taxed on the excess of the amount of money received plus the fair market value of the property received over his adjusted basis of his stock. His adjusted basis is the aggregate of the amounts he contributed to the club minus any distributions he received from the club which, because the club did not have sufficient earnings and profits to cover them at the time of the distribution, were tax free. (Code Sec. 1016 (a) (4).)

How does this differ from the gain on liquidation of a partnership? The partner annually paid tax on his distributive share of all earnings. These earnings were credited to his account, which was charged with any actual distribution he may have received. If a partner receives both money and stock or securities in liquidation, only the money is taken into account in determining his gain. The stock or securities take as their basis the difference between the member's basis of his liquidated interest and the amount of money he received on the liquidation. (Code Sec. 732(b).) If there is a technical termination of the partnership and the business is continued, the partners are considered as having transferred their shares of the terminated partnership's assets to the new partnership as a contribution of capital.

Loss is recognized to a partner only upon liquidation of his entire interest in the partnership, and only if the property distributed to him consists solely of money (and certain receivables and inventory—items which an investment club normally does not have).

No special liquidation forms are required by a partnership. Corporations must, however, file form 1099L for each liquidation distribution of $600 or more to any one member during any calendar year.

Personal property taxes, mentioned in the list of deductible expenses, are taxes common to both corporations and partnerships, although the rates and methods of assessment differ in the various States.

In review corporations pay income, franchise and personal property taxes. Partnerships report on information return 1065 the distributive amounts for tax purposes and each partner pays his income tax, but the partnership pays the personal property tax.

One last word of caution. Investment clubs, whether partnerships or corporation, are organized for profit and in no way should the American Society of Women Accountants name be associated with an investment club. The ASWA is nonprofit and it is of the utmost importance that no member or group of members do anything which might endanger the Federal Income Tax exemption held by ASWA.

A closing comment: if all the Federal, State and Local rules and regulations are followed, as in any business venture, there is no reason why THE INVESTMENT CLUB should BEWARE.

*From a paper presented at the Eastern Regional Conference A.S.W.A. May 1962, Columbus, Ohio.*


**STATEMENT REQUIRED BY THE ACT OF AUGUST 24, 1912, AS AMENDED BY THE ACTS OF MARCH 3, 1933, JULY 2, 1946 AND JUNE 11, 1960 (74 STAT. 208) SHOWING THE OWNERSHIP, MANAGEMENT, AND CIRCULATION OF**

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2. The owner is: (If owned by a corporation, its name and address must be stated and also immediately thereunder the names and addresses of stockholders owning or holding 1 percent or more of total amount of stock. If not owned by a corporation, the names and addresses of the individual owners must be given. If owned by a partnership or other unincorporated firm, its name and address, as well as that of each individual member, must be given.)

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MARGUERITE REIMERS, Editor

Sworn to and subscribed before me this 11th day of September, 1962.

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Rachel H. Faucher
(My commission expires Sept. 10, 1965)