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The Taxation of Mutual Fund Shareholders

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with the tax situation of the self-employed, including professionals, under the Keough Bill. The congressional intent to limit tax privileges to the self-employed within the confines of the Keough Bill will be sure to protect the proposed regulations from vigorous attack.

From the foregoing analysis it would not be unreasonable to conclude that the *raison d'être* of chapter 156A no longer exists. There are, perhaps, peripheral reasons for incorporating under this statute, but they are not obvious. The uniqueness of a professional corporation and the resultant lack of case law in the area, make it fertile ground for litigation, giving body to the statutory framework. It is improbable that many professionals will desire to embark on such an adventure in view of the limited benefits to be derived therefrom.

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TAXATION

THE TAXATION OF MUTUAL FUND SHAREHOLDERS

The increased number of relatively low income investors during the past decade has focused special attention on the open-end investment company, commonly called the Mutual Fund.¹ This is not to suggest that large investments are not made in Mutual Funds by individual shareholders, but, rather, implies one of the original objects of the Mutual Fund. Professional investment management simply cannot be afforded by investors whose holdings are not of a very substantial quantity. Investment consultants, furthermore, are not interested in handling small accounts because of the percentage fee basis on which they conduct business. The Mutual Fund was conceived as a means of providing professional management for all sizes of investments. To this end a relatively simple scheme was devised whereby investors contribute what they wish to the assets of the fund, receiving in return shares or certificates indicating the amount of their investments. All the assets of the fund are then turned over to investment managers who, for a fee, usually a fraction of a percentage, invest and dispose of the assets among securities according to the policies and purpose of the fund. The fund then passes along to its shareholders the income from its investments as well as its capital gains provided the latter are not reinvested. At any time the shareholder can "redeem" his shares; that is, cash them in for their net asset value which is computed twice daily by most funds. The plan is roughly analogous to an agency relationship between the fund and its shareholders although in this respect one crucial distinction is that the shareholder has no property interest in the securities purchased by the fund.

Because of the unique structure and purpose of the Mutual Fund, the fund and its shareholders are subject to special provisions in the tax laws which reflect the "conduit" nature of the fund. Earnings and profits of the

¹ For all practical purposes the distinction between open and closed-end investment companies is that the former will redeem its own shares.

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open-end investment company are channeled directly to the shareholders. Equity, therefore, requires a method of taxation different from that of most corporations and this in turn affects the shareholder-taxpayer as well.

To be eligible for special tax treatment the fund must derive at least 90 per cent of its gross income from dividends, interest, and gains from the sale or other disposition of stock or securities.² In addition, there are specific requirements with respect to the nature of the securities involved and the duration of their retention by the fund.³ The Mutual Fund itself pays no income tax. That portion of its income comprised of dividends received is distributed to its shareholders who must include their share in their gross incomes.⁴ Such dividends received by the shareholders are, however, subject to the one hundred dollar exclusion⁵ and to the two per cent credit⁶ provided that the dividends are derived from investments qualifying for such exclusion and credit.⁷ With respect to gain or loss to the shareholder on the redemption of his shares, Mutual Fund stocks are treated, in general, like other corporate securities. A special provision is applicable to losses on the disposition of stock held less than thirty-one days.⁸ The most significant tax aspect of Mutual Funds, distinguishing it from other securities, refers to the treatment of capital gains earned by the fund. A twenty-five per cent capital gains tax is paid by the fund on those capital gains retained by it. These gains are determined by the excess of the net long-term capital gains over the net short-term capital losses and the capital gains distributed to the shareholders.⁹ Where all of the fund's capital gains have been distributed through capital gains dividends, of course, no tax is imposed upon the fund. The shareholder, in that case, pays a capital gains tax on the amount received by him designated a capital gain. Many funds provide their shareholders with an option of receiving capital gains dividends in cash or in stock. In either event, it is treated as a gain from the sale or exchange of a capital asset held for more than six months.¹⁰ Capital gains dividends may not be the subject of any dividends received credit or dividend exclusion mentioned earlier. In all cases the fund is required to notify its shareholders of the nature of any distribu-

² Int. Rev. Code of 1954 (hereinafter IRC), § 851(b)(2).

³ IRC, § 851(b).

⁴ IRC, § 61(a)(7).

⁵ IRC, § 116(a), as amended, Rev. Bill of 1964,—Stat.—(1964).

⁶ IRC, § 34(a), as amended, Rev. Bill of 1964,—Stat.—(1964). The old 4% credit applies to dividends received prior to Jan. 1, 1964. After Jan. 1, 1965, the credit will be totally eliminated, while for the calendar year 1964, the 2% credit is applicable.

⁷ Each shareholder is notified as to what percentage of the dividends qualify for the exclusion and credit.

⁸ Treas. Reg. § 1.852-4(5)(d) (1957): . . . if any person, with respect to a share of regulated investment company stock acquired by such person after December 31, 1957, and held for a period of less than 31 days, is required . . . to include in gross income as a gain from the sale or exchange of a capital asset held for more than 6 months—the amount of a capital gain dividend, or an amount of undistributed capital gains, then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share of stock as a loss from the sale or exchange of a capital asset held for more than 6 months. . . .

⁹ IRC, § 852(b)(3)(A).

¹⁰ IRC, § 852(b)(3)(B).

tion made to them. In the event that the fund does not distribute all of its capital gains it would pay a twenty-five per cent tax on the undistributed amount. Each shareholder is advised of the retention of these gains and must report on his own tax return his proportionate share of the aggregate undistributed capital gain.¹¹ But since the tax has already been paid by the fund, the shareholder is permitted a credit of the twenty-five per cent tax paid. The basis of the shares held are then adjusted to include an increase by seventy-five per cent of the shareholder's interest in the gain.¹² If the shareholder is in a tax bracket imposing a capital gains tax of less than twenty-five per cent he will be entitled to a refund on the excess portion of the tax paid by the fund.

A question may arise as to what tax treatment will be accorded undistributed capital gains which in a succeeding taxing period are distributed. The question is probably academic as in practice all undistributed capital gains are reinvested by the fund. However, in order to receive capital gains treatment, such gains must be distributed in the year realized.

In the event that more than fifty per cent of the value of the fund consists of shares or securities in foreign corporations, the fund, consistent with the "conduit" theory, may elect to have its foreign tax credit taken by its shareholders in which case the shareholder would report his proportionate share of the foreign tax paid as a credit on his income tax return.¹³ This, in general, is the extent of the unique income tax rules applicable to shareholders of Mutual Fund securities.

Recently new regulations were issued with respect to the determination of the fair market value of Mutual Fund shares for purposes of computing Gift and Estate taxes.¹⁴ With respect to decedents dying after October 10, 1963, and gifts made after that date, the value of the shares held or donated is determined by the public offering price of the shares on the date of death or of the gift, including a sales charge.¹⁵ Formerly the value was equivalent to the redemption value. The new rules add to this the sales charge affixed to the purchase of new shares. These new regulations have not yet been subject to judicial review, but some investment consultants believe the rulings will be challenged. If the number of shares involved is substantial the sales charge will significantly increase the value thereof. The sales charge, it is said, is not truly part of the shares' value.

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¹¹ IRC, § 852(b)(3)(D)(i), as amended, Rev. Bill of 1964,—Stat.—(1964).

¹² IRC, § 852(b)(3)(D)(iii).

¹³ IRC, § 853(b).

¹⁴ CCH Fed. Est. & Gift Tax Rep. ¶ 1211(b)(Oct. 17, 1963); ¶ 3360(b)(Oct. 17, 1963).

¹⁵ *Ibid.*