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Federal Income Taxation of Regulated Investment Companies

William Alfred Kern

FEDERAL INCOME TAXATION OF REGULATED INVESTMENT COMPANIES

*William Alfred Kern**

Under part I of subchapter M of the Internal Revenue Code of 1954 (sections 851-55),[1] certain investment companies may obtain a virtual exemption from federal income taxation. The operation of subchapter M is widely known and relatively simple: investment companies that distribute all or substantially all of their income to shareholders are exempted from taxation on the amounts so distributed. However, this item of special-industry legislation, now in effect for more than a quarter of a century[2] and affording several hundred companies tax relief amounting to hundreds of millions of dollars annually, has given rise to only two litigated tax disputes (one involving a shareholder rather than a fund) and to less than a dozen published revenue rulings.

The purpose of this article is to provide a detailed description of the circumstances under which investment companies may obtain this favored tax treatment. The five sections comprising part I of subchapter M are of moderate length, but each of them incorporates concepts that, to be understood, must be pursued through other Code sections and provisions of other federal laws, notably the Investment Company Act of 1940.

The format of part I of subchapter M is as follows: section 851 "defines" the class of companies qualified for special treatment. Section 852 is the operational provision, stating certain rules for the taxation — or more precisely, the nontaxation — of qualified companies. Section 853 provides for the pass-through of foreign tax credits to shareholders of companies whose assets are heavily concentrated in the securities of foreign issuers. Section 854 grants shareholders the dividends-received exclusion (and formerly, the dividends-received credit), thereby placing investment company shareholders on a par with the holders of shares in operating companies. And finally, section 855 facilitates compliance with the dividend payment requirements by giving investment companies a look-back period following the close of their taxable years, treating dividend declarations and payments as though they were made during the preceding tax period. A related group of sections not contained in subchapter M, sections

* Member, Connecticut Bar, United States Court of Appeals for the District of Columbia Bar, Indiana Bar; B.A., Yale University, 1955; LL.B., Yale Law School, 1961; Tax Counsel, The Lincoln National Life Insurance Company; former staff attorney, Division of Corporate Regulation, Securities Exchange Commission; former staff attorney, Refund Litigation Division, Office of the Chief Counsel, Internal Revenue Service.

1 Hereafter, the Internal Revenue Code of 1954 will be referred to as the Code or the 1954 Code, and the Investment Company Act of 1940, 54 Stat. 847, 15 U.S.C. §§ 80a-1 to -52 (1964), will be referred to at times as the ICA.

2 The rudiments of subchapter M came into the tax law as § 48(e) of the Revenue Act of 1936, ch. 690, § 48(e), 49 Stat. 1708, which provided limited tax relief for "mutual investment companies." There are no public records relating to the background of this legislation; the provision was added as a floor amendment in the House. Unlike its successors in the 1939 Code (supplement Q) and in the 1954 Code (subchapter M), it benefited only "open-end" companies, not "closed-end" companies.

1246-48, affords similar treatment to foreign investment companies registered with the Securities and Exchange Commission.[3]

An understanding of subchapter M presupposes a general familiarity with the Investment Company Act, but that act will not be described here except to the extent necessary to make intelligible the comments pertaining to specific provisions of the Revenue Code. Part II of subchapter M (sections 856-58) deals with similar treatment available to another form of intermediate financial institutions, the real estate investment trust. An analysis of those provisions is outside the scope of this article, and references to subchapter M should be understood to pertain only to part I thereof.

Definitions

The benefits of subchapter M are available only to "regulated investment companies," a term defined in section 851. In general, "regulated investment companies" are domestic corporations, other than personal holding companies, falling into one of two types:

> (1) those companies that, during the entire taxable year, have been registered with the Securities and Exchange Commission as either management investment companies[4] or as unit investment trusts; or
> (2) those common trust funds that are (i) excluded from the Investment Company Act's definition of investment companies by section 3(c)(3)[5] and (ii) are not included in the definition of common trust funds of section 584 of the 1954 Code.[6]

Although the benefits of subchapter M are available only to domestically

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3 Although these tax provisions purport to afford relief to investment companies domiciled anywhere outside the United States, the applicable ICA rules effectively limit such benefits to Canadian companies. 17 C.F.R. § 270.7d-1 (1964).

4 The term "investment company" is defined by § 3(a) of the ICA as any issuer of securities primarily engaged in the business of investing, reinvesting or trading in securities. "Management" investment company is a residual category defined as an investment company other than a face-amount certificate company or a unit investment trust. Investment Company Act, §§ 4(1)-(3).

5 Section 3(c)(3) of the ICA excepts from investment company status the ordinary business activities of banks, insurance companies, savings and loan associations, common trust funds and like institutions.

6 Section 584 defines "common trust fund" as a fund that is maintained by a bank

> (1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and
> (2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks.

State banks, not subject to the Comptroller's regulation, may qualify their common trust funds for § 584 treatment by complying with the Comptroller's regulations. Since such funds are not treated as taxable entities under § 584(b), it would work no tax benefit for them to be treated as regulated investment companies. The predecessor of § 584 was brought into the tax law by the Revenue Act of 1936 at the same time as the original "mutual investment company" provision. Both provisions were responsive to Brooklyn Trust Co. v. Commissioner, 80 F.2d 865 (2d Cir.), *cert. denied,* 298 U.S. 659 (1936), which held that a bank common trust fund was an association taxable as a corporation.

chartered business entities,[7] the term "corporation" is defined by section 7701(a)(3) of the 1954 Code and the Regulations issued thereunder to include many entities that would not be corporations under state law nor regarded as such for purposes of any other law. Furthermore, a registered investment company may be organized under local law provisions that purport to characterize it as a very different sort of entity,[8] or it may in substance be an activity carried on by a company which itself neither purports to be an investment company nor is eligible to register as such.[9]

The expression "entire taxable year" must be read in the light of Rev. Rul. 56-499,[10] which held that a company organized in 1953 but not active until its registration with the SEC became effective in August of 1955 is "considered to have been registered" during the entire year 1955.

As the foregoing definitions suggest, there is an interplay between the Investment Company Act and subchapter M of the 1954 Code. But in their different ways, these acts pertain to kinds of entities that are not coterminous. As indicated, subchapter M treatment may theoretically be available to some common trust funds, although they are excluded from the ICA's definition of investment companies.[11] On the other hand, face-amount certificate companies are excluded from the ambit of subchapter M, although they are investment companies under the ICA. Other points where the coverage of these two statutes varies will be noted in the ensuing discussion.

Limitations

Section 851(b) (limitations) excludes certain businesses otherwise falling within the definition of regulated investment companies. In order to qualify for subchapter M benefits, a company must:

(1) file an election to be treated as a "regulated investment com-

7 Qualifying foreign investment companies doing business in the United States may be taxed under § 1247 of the Code, which, in general, provides treatment similar to that afforded by subchapter M.

8 The Variable Annuity Life Insurance Company is a registered investment company that was organized under District of Columbia law as a life insurance company.

9 The National Variable Annuity Company of Florida, a stock life insurance company organized under the Florida Insurance Code, has caused its Separate Account — not National Variable itself — to be registered under the ICA as an open-end management investment company. Noteworthy also are the exemptions from sections of the ICA granted to the First National City Bank on behalf of its proposed Commingled Investment Account. See Investment Co. Act Release No. 4538 (March 9, 1966).

10 1956-2 Cum. Bull. 497.

11 To be sure, there is no public record that any § 851(a)(2) company exists. The provision was inserted at the insistence of Mr. George A. Wood, representing the Brooklyn Trust Company, whose Composit Fund, Series A, was not registered as an investment company. Presumably, the Composit Fund was thought to fall outside the definition of § 584, though subsequent events may have shown that assumption to have been mistaken. The Comptroller of the Currency argued before the Subcommittee on Interstate and Foreign Commerce of the House of Representatives in 1964 that bank common trust funds operated under his then newly revised Regulation 9, *i.e.*, managing agency accounts, would be excluded from the coverage of the ICA by § 3(c)(3). He also sought and, after several months, obtained a ruling to the effect that such activities would constitute bank common trust funds under § 584 of the 1954 Code. Rev. Rul. 64-59, 1964-1 Cum. Bull. 193. Thus, even if the Comptroller's view had prevailed, the modified form of bank collective trust fund he envisioned would not have been a § 851(a)(2) company, but rather a § 584 bank trust fund.

pany" with its tax return unless it has filed such an election with its return for a previous year that began after December 31, 1941;

(2) derive at least ninety percent of its gross income from dividends, interest and gains from the sale or other disposition of stock or securities;[12]

(3) derive less than thirty percent of its gross income from gains on the sale of stock or securities held for less than three months; and

(4) meet certain requirements relating to diversity of investments which do not lend themselves to ready summarization.

Each of the foregoing points requires brief elaboration.

Election

Under Treasury Regulations,[13] the "election" to be treated as a regulated investment company is made by computing taxable income as a regulated investment company in the tax return for the first year for which the election is available. No other method of making the election is permitted. Once made, the election is binding for all future years, though the company may fail to qualify for subchapter M treatment for any one of numerous other reasons. For example, an investment company which had in a prior year elected to be treated as a regulated investment company could fail to qualify in a given year by manipulating its asset holdings or its income source, either of which would have the practical effect of revoking a purportedly binding election. A failure to make sufficiently large dividend payments will not in form revoke the election to be a regulated investment company, but it has a similar practical effect.[14]

The Regulations do not state whether an election is considered to be timely if made in a return which is filed untimely. Litigation on the question of timeliness with respect to other, analogous election provisions of the Code leaves the answer in doubt. The Regulations imply that a company that has not elected to be treated as a regulated investment company in an earlier year in which it was eligible to make that election may not do so in a later year.[15] Seemingly, the relevant Regulation goes well beyond the requirement imposed by the statutory provision, section 851(b)(1), and its literal enforcement presumably would be held invalid if challenged in litigation.

Income Restrictions

The second and third limitations of section 851(b), restricting income sources, have no close relationship to any requirements imposed by the ICA. Under the second limitation, a company deriving more than ten percent of its

12 The Revenue Code recognizes a distinction between stock and securities, although the distinction is nowhere clearly defined in the Code. In general, the distinction observed is that between ownership and what might be called creditorship. In § 2(a)(1) of the Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77b(1) (1964), the term "security" is given a broad definition, and that definition was incorporated into § 2(a)(35) of the ICA and elsewhere in the securities regulation statutes.

13 Treas. Reg. § 1.851-2(a) (1957), as amended, T.D. 6598, 1962-1 Cum. Bull. 92.

14 See Treas. Reg. § 1.852-1(b) (1957), as amended, T.D. 6598, 1962-1 Cum. Bull. 92; Rev. Rul. 58-466, 1958-2 Cum. Bull. 379.

15 *But see* Rev. Rul. 56-499, 1956-2 Cum. Bull. 497, discussed in text accompanying note 10 *supra*.

income from sources other than dividends, interest and profits on trading in securities is not regarded as a regulated investment company. In contrast, a company might derive considerably more than ten percent of its income from dealings in real estate and still be regarded as an investment company for ICA purposes. The presence of illiquid assets exceeding ten percent of total asset value might impair a company's ability to make timely redemptions of securities and thus bring into doubt its status as an open-end company, but that would constitute a neutral determination for tax purposes.

In Rev. Rul. 64-247,[16] the Internal Revenue Service ruled that amounts recovered by a regulated investment company in compromise settlement of a suit brought by the company against its former officers and directors constituted "gross income" in the year of recovery. The amount recovered exceeded ten percent of "gross income" for the year. (Indeed, it was more than thirty percent of its gross income for the year.) Notwithstanding these considerations, the ruling concluded that the receipt of that amount of gross income from sources other than those described in section 851(b)(2) (dividends, interest and profits on sale of securities) would not destroy the company's status as a regulated investment company.[17] The writer finds it impossible to reconcile the ruling's conclusions with its stated premise that the amount recovered from litigation constituted gross income. If, however, the amount recovered were regarded as an expense reduction, rather than gross income, the conclusion would be supportable. While the ruling surmounts its own obstacle in properly disposing of the status issue, the treatment of the recovered amount as gross income poses other problems which are discussed under section 854.

On the other hand, the Service held in Rev. Rul. 63-183[18] that income derived from the issuance of "put" and "call" options is not to be regarded as gains from the sale of stock or securities. Hence, in the case of an investment company deriving more than ten percent of its income from that source, the limitation of section 851(b)(2) will come into play, and the company will lose its status as a regulated investment company.

Under the third limitation, regulated investment companies must not derive more than thirty percent of their gross income from trading in securities held for less than three months. Given proper disclosure — which is required in any case — the Investment Company Act does not prohibit a registered investment company from devoting itself primarily to the quest for short-term profits. It was held in Rev. Rul. 63–118[19] that gains from the sale of securities retained for less than three months are not to be offset by losses incurred upon disposition of such holdings for purposes of section 851(b)(3).

Diversification

The fourth limitation, section 851(b)(4)(A) and (B), pertains to diversification. Here, the tax requirement in part parallels section 5(b)(1) of

16 1964-2 CUM. BULL. 179.
17 To the same effect is Special Ruling, August 6, 1963; CCH 1963 STAND. FED. TAX REP. ¶ 6618.
18 1963-2 CUM. BULL. 285.
19 1963-1 CUM. BULL. 121.

the Investment Company Act,[20] which defines diversified management companies. But, it also departs from the format of section 5(b)(1) at some points. Under section 851(b)(4), a regulated investment company must, in general, have at least fifty percent of the value of its total assets in either cash, cash items, government securities, securities of other investment companies[21] or in securities of other issuers.

It may clarify discussion at this point to refer to the fifty percent of an investment company's assets that must meet the diversification requirements of section 851(b)(4)(A) as the "restricted half," and to refer to the other fifty percent of the assets as the "unrestricted half." Subsection (b)(4)(A) imposes no limitations on the form in which the "unrestricted half" of the assets may be held, but subsection (b)(4)(B) does impose an overall limitation on the form in which both "restricted half" and "unrestricted half" assets may be held. These requirements of subsection (b)(4)(B) are considered in a later section.[22]

With respect to the securities of "other issuers" in the "restricted half" assets, section 851(b)(4)(A)(ii) prohibits a regulated investment company from owning more than ten percent of the outstanding voting securities[23] of any one issuer and from investing more than five percent of the total value of its assets in any one issuer. For convenience, these proscriptions will be referred to as the "5-and-10" rules. So far, the tax pattern follows the Investment Company Act provision, except that the Code merely requires fifty percent of an investment company's assets to be in the restricted forms discussed above, whereas section 5(b)(1) of the ICA requires that seventy-five percent of a diversified management company's assets be so restricted.

Investments in "Development" Companies

Section 851(e) affords limited relief from the "5-and-10" rules to investment companies that are principally engaged in furnishing capital to other businesses primarily concerned with the development or exploitation of inventions, technological improvements, new products or processes not previously available commercially. Generally, subsection (e) is useful only to closed-end companies. Most open-end companies limit their portfolio holding to established or even to "blue-chip" companies, which are not principally engaged in the

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20 Section 5(b)(1) of the ICA provides:

> "Diversified company" means a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash or cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.

21 Section 12(d) of the ICA prohibits an investment company from owning more than 5% of the shares of another investment company whose policy is to concentrate its investments in a single industry or group of industries or more than 3% of the voting shares in an investment company that does not concentrate its investments. If, however, one investment company owns more than 25% of the voting shares of another, no limitations apply.

22 See discussion under Overall Diversity Requirements *infra*.

23 "Voting securities" are not defined by the Regulations under subchapter M. The term "voting" presumably has the meaning assigned it in other tax provisions. The term "voting stock" has been defined to exclude, "generally," shares with contingent voting rights unless the contingency has in fact occurred. Treas. Reg. § 1.302-3(a) (1955).

development of new products. Under section 851(e), the requirement that a regulated investment company shall not include the shares of any issuer in which it owns more than ten percent of the voting stock in the computation of its section 852(b)(4)(A) "restricted half" holdings is waived entirely and the "five percent rule" is modified.

In form, the rule providing that shares of a single issuer representing more than five percent of the investment company's total assets may not be included in the computation of "restricted half" holdings is retained, but the manner of computing the "five percent" holdings is relaxed. Such holdings may be included if the *cost* of such shares (rather than, as is ordinarily the rule, present market value) does not exceed five percent of the company's total asset value.[24]

In order for section 851(e) to become effective, the investment company must obtain certification from the Securities and Exchange Commission not more than sixty days prior to the close of the taxable year stating that it is principally engaged in the furnishing of capital to "development" corporations. Although the provision speaks in terms of certification "determine[d] in accordance with regulations" issued by the SEC, no such regulations have in fact been issued. In view of the durability of a certification under section 851(e)(3), it is difficult to see why such a company is required to put off its request for a subsection (e)(1) certification until sixty days prior to the close of the first taxable year for which certification would be effective.[25]

Section 851(e)(2) denies subsection (e)(1) status when more than twenty-five percent of an investment company's total assets are comprised of securities in development companies in which the investment company holds more than ten percent of the outstanding voting securities *and* when it has held such securities for more than ten years. With respect to any fiscal quarter in which such holdings exceed twenty-five percent of the investment company's total assets at the close of the quarter, the investment company has a thirty-day grace period in which to retain section 851(e)(1) status by reducing such holdings to twenty-five percent or less.

Section 851(e)(3) provides certain rules for the determination of status as an investment company principally engaged in furnishing capital to development companies. Also, it empowers the SEC to issue rules, regulations and orders and to conduct such public or private investigations and hearings as it may deem appropriate.

Overall Diversity Requirements

As previously noted, section 851(b)(4)(B) places an overall limitation on the percentage of the "value" of a regulated investment company's total assets which may be invested in the securities of any one issuer or group of controlled issuers other than a governmental unit or other investment company.[26]

24 Three examples of the application of this provision are set forth in Treas. Reg. § 1.851-8(b)(2) (1957).

25 For an example of a certification, see Greater Washington Industrial Invs., Inc., Investment Co. Act Release No. 3929 (March 12, 1964).

26 The fact that an investment company may have more than 25% of its assets in the securities of a single issuer if that issuer is another investment company makes it possible for unit investment trusts to avoid the limitation of § 851(b)(4)(B). Otherwise, such trusts would not

The limitation (twenty-five percent) applies both to a single issuer and also to any *group* of companies "controlled" by the investment company and determined by the Secretary of the Treasury to be in the same or similar lines of business. The fragmentation of administrative responsibilities under subchapter M between the Secretary of the Treasury (including his delegates to the extent that such powers and responsibilities have been delegated), the Commissioner of Internal Revenue and the Securities and Exchange Commission would presumably become cumbersome if there were in fact many situations requiring the discharge of duties involving discretionary determination.

The operative terms of section 851(b)(4)(B) are defined in section 851(c). "Control" is defined by subsection (c)(2) to mean the ownership of at least twenty percent of the total combined voting power of all classes of voting stock. A "controlled group" is defined by subsection (c)(1) as one in which twenty percent or more of the total combined voting power of all classes of voting stock of each of the corporations other than the investment company is owned by one or more other members of the group *and* the investment company owns at least twenty percent of the stock in at least one of the other corporations.

With an exception to be noted, "value" is defined by subsection (c)(4) to mean market quotations where available and otherwise the directors' good-faith determinations. The exception pertains to the value of shares in majority-owned subsidiaries that are themselves investment companies. Those shares are valued at the *higher* of market or asset values. In determining the value of securities of another issuer held by any one investment company, the securities of that issuer held by any other company that is a member of the "controlled" group are added to the shares held directly by the investment company.

Determination of Status as Regulated Investment Company

Section 851(d) states in substance that a company whose holdings in prior quarters satisfied the diversity requirements of subsection (b) will not lose its status as a regulated investment company in any subsequent quarter because of nondiversification, unless its failure to satisfy one of the diversification "requirements" is occasioned in whole or in part by *acquisitions*. In other words, mere fluctuations in the market values of portfolio holdings would not cause a company to lose regulated investment company status, notwithstanding the fact that such fluctuations might cause the holdings to fail to satisfy the five percent rule of section 851(b)(4)(A)(ii) or the twenty-five percent rule of section 851(b)(4)(B). Presumably, a reduction in shares outstanding by a portfolio company so that an investment company theretofore holding less than ten percent of its voting shares but thereafter holding more than ten percent also would not destroy regulated investment company status. The Regulations are silent on this point.

Sales resulting in insufficient diversification do not disturb an investment

typically qualify since they ordinarily invest all assets in the shares of a single open-end management investment company. A unit investment trust organized for the purpose of affording its shareholders a means of accumulating an interest in the shares of a single (noninvestment company) issuer apparently would not qualify for subchapter M treatment, though apparently the Internal Revenue Service has ruled on the point.

company's status, although they too could obviously result in a failure to satisfy one or more of the diversification requirements of section 851(b)(4). The Service has ruled that involuntary acquisitions occasioned by distribution of shares to an investment company pursuant to an antitrust divestiture decree or a reorganization will bring section 851(b)(4) into play.[27] The ruling seems inconsistent with the statutory scheme, which generally attaches no punitive consequences to diversification imbalances not brought about by affirmative action of the investment company.

Although acquisitions that do result in a company's failure to meet the diversification requirements will preclude subchapter M treatment if not remedied, section 851(d) provides a thirty-day grace period in which holdings may be brought back into conformity with subsection (b) with retroactively beneficial results. Section 5(c) of the Investment Company Act, after which Revenue Code section 851(b) was obviously modeled, contains no provision for retroactive reconformity to the diversification requirements for diversified investment companies. But under the Investment Company Act, no sanction attaches to the change from diversified status to nondiversified status; prior shareholder approval is sufficient.

The Taxation of Regulated Investment Companies

The heart of subchapter M is section 852, which provides that a regulated investment company paying at least ninety percent of its ordinary income as dividends to shareholders and complying with certain Treasury Regulations pertaining to the identification of actual owners of outstanding shares[28] may claim certain deductions from taxable income, *including a deduction for dividends paid.* Thus, a regulated investment company that pays ninety percent of its investment company taxable income as dividends would be taxable (at the normal and surtax rates otherwise applicable to corporations under section 11 of the Code) only on the remaining ten percent of undistributed investment company income, whereas one that pays eighty-nine percent of its investment company taxable income as dividends to shareholders would be taxed on its entire income. To be sure, an investment company not satisfying the dividend distribution requirement would not be taxed as heavily as might be supposed, inasmuch as it is entitled to the eighty-five percent dividends-received deduction on most holdings.[29]

In recognition of the fact that it is frequently difficult or impossible for an investment company to declare dividends during its taxable year amounting to ninety percent of its taxable income, section 855(a)(1) creates a two-and-one-half-month look-back period following the close of the taxable year in which additional dividend declarations may be made in satisfaction of the

27 Rev. Rul. 63-170, 1963-2 CUM. BULL. 286.

28 The share ownership identification provision enables the Internal Revenue Service to identify these companies, which are in fact personal holding companies. In certain cases, an investment company having too few shareholders would also be a personal holding company and thus taxable as such, notwithstanding that it might satisfy every other requirement under subchapter M. Under § 851(a) a regulated investment company is, by definition, a company "other than a personal holding company."

29 INT. REV. CODE OF 1954, § 243(a).

section 852(a)(1) requirement. Literally, the additional dividend *declaration* may be made within the period prescribed by law for the filing of a timely return (ordinarily, the 15th day of the third month following the close of the taxable year), *including any granted extension periods.*

Section 855(a)(2) provides that the additional dividends may be *paid* any time within twelve months of the close of the taxable year for which they were declared, provided that they be paid no later than the next regular dividend payment date. On the other hand, amounts so received by shareholders must be treated by them, under section 855(b), as having been received in the year in which they were actually paid. Certain notice-to-shareholder requirements[30] are satisfied if notice is given within forty-five days after the close of the taxable year in which the distributions were made.

Adjustments to Investment Company Taxable Income

In addition to the deduction for dividends paid of section 852(b)(2)(D), there are four other categories of adjustments to taxable income listed in section 852(b)(2). The excess of net long-term capital gain over net short-term capital loss, if any, is excluded by subsection (b)(2)(A) from investment company taxable income and is given separate long-term capital-gain treatment under section 852(b)(3). The excess, if any, of net short-term capital gain over net long-term capital loss constitutes a portion of the ordinary income, of which ninety percent must be distributed as dividends in order for the company to obtain subchapter M benefits. However, a net capital loss may be carried forward within the limits set by section 1212.[31] The net operating loss deduction of section 172 is disallowed by subsection (b)(2)(B). Certain special deductions for corporations[32] are disallowed, with the exception of the organizational expense amortization provision of section 248. The significant deductions that are disallowed under this heading are the deduction for partially tax-exempt interest[33] and the intercorporate dividends-received deduction.[34] Finally, subsection (b)(2)(E) requires that taxable income be computed without regard to section 443(b), which requires that a taxpayer's income be "annualized" when a taxpayer files a short-period return in order to change to a new tax accounting period.

The foregoing adjustments to ordinary income are, with the exception of the dividends-paid deduction, relatively mechanical in nature, and they apparently give rise to few problems. The allowance of the net operating loss carry-back or carry-forward deductions, or the allowance of the eighty-five percent dividends-received deduction for corporations would obviously be inappropriate where a corporation is otherwise virtually exempted from taxation. As noted, though, the dividends-received deduction is available in years when an invest-

30 INT. REV. CODE OF 1954, §§ 852(b),(c) (relating to capital gains dividends), 853 (relating to foreign tax credits) and 854 (relating to dividends received credits).
31 Rev. Rul. 60-217, 1960-1 CUM. BULL. 301.
32 INT. REV. CODE OF 1954, §§ 241-48.
33 INT. REV. CODE OF 1954, § 242.
34 INT. REV. CODE OF 1954, §§ 243-46.

ment company fails to make the ninety percent dividend distribution as required by section 852(a)(1).[35]

Unlike the other adjustments, the dividends-paid deduction of section 852(b)(2)(D) has given rise to difficult problems of interpretation. A few investment companies have plans under which all ordinary income dividends, as well as capital gain distributions, will be reinvested in additional shares of the company. The question arises, then, whether such reinvested dividends have in fact been "paid" to the shareholders who have elected to be governed by the provision.

A literal reading of Code sections bearing on the problem would suggest that the form of dividend payment effected under such plans would not satisfy the dividend distribution requirement of section 852. An involved series of cross-references leads one from section 852 to section 316 (dividends defined) and then to section 317 (other definitions), where one learns that shares of the issuer do not constitute "property" for the purpose of the dividend distribution requirement of section 852 and, hence, cannot be a "dividend" when distributed to shareholders on account of shareholdings.

However, the Service has taken the position that dividend reinvestment plans create a procedure that is functionally the equivalent of a cash distribution followed by an immediate reinvestment in additional shares where the shareholder can cancel his election to have dividends reinvested in any given year.[36] Support for this position is found in sections 2(a)(31) and 22(e) of the ICA, which impose upon open-end investment companies otherwise qualified for regulated investment company status the continuing obligation to redeem their shares within seven days after demand by their shareholders. An irrevocable shareholder's agreement to have dividends reinvested during a period of several years would present a more serious issue than the Service has heretofore been asked to rule on.

The soundness of Rev. Rul. 65–89 presumably would be tested by a shareholder who, having "received" such dividends, invoked section 305(a) as justification for not including them in gross income. This ruling does not purport to cover a situation in which there is any substantial restriction on the right of a shareholder to withdraw the amounts so credited to his account. Such a restriction might be deemed to exist if the fund imposed a redemption charge, or possibly, if the fund imposed a sales charge (load) on the amounts reinvested.

The Service has also ruled that dividends declared and paid in securities from the investment company's portfolio holdings do not give rise to gain or loss to the company, notwithstanding the fact that the distributed securities may have appreciated or depreciated substantially. In such a case, the company's deduction is limited to its adjusted basis in the shares distributed.[37]

Capital Gain Treatment

In summary, the excess of net long-term capital gain over net short-term

35 See text accompanying note 29 *supra*.
36 Rev. Rul. 65-89, 1965-1 Cum. Bull. 265.
37 Rev. Rul. 57-421, 1957-2 Cum. Bull. 367.

capital loss will be taxed at the applicable capital gain rates only once, whether such gains are distributed to the shareholders as capital gain dividends or retained by the investment company. However, the capital gain tax rate is not necessarily the same for corporations as it is for individuals, and the mechanism for handling the two situations varies considerably. For simplification, consideration will be given first to corporate capital gains.

Under section 852(b)(3), a regulated investment company is taxed at the flat rate of twenty-five percent on the excess of net long-term gain over net short-term loss to the extent that such gain is not paid out as a capital gain dividend. The expression "capital gain dividend" is defined by section 852(b)(3)(C) as

> any dividend, or part thereof, which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including capital gains dividends paid after the close of the taxable year described in section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated.[38]

Hence, the investment company will either be relieved of capital gains tax or else will pay a tax at the flat twenty-five percent rate, depending upon whether or not it distributes its capital gain and so designates it in a timely written notice to shareholders.

The shareholder who receives a capital gain dividend is entitled to treat that amount as the proceeds from the sale or exchange of a capital asset held for more than six months, regardless of the period during which he held shares in the company.[39] That is to say, the shareholder may treat capital gain dividends as long-term capital gains even though they might be received within a week of the date of purchase of shares generating the dividends. Furthermore, the individual shareholder's capital gain tax rate will never exceed twenty-five percent and, in some cases, will be less than ten percent. This result follows because individual shareholders may elect, under section 1201(b), to have net long-term capital gains taxed either at the flat rate of twenty-five percent, or at one-half the highest rate otherwise applicable to their ordinary income, whichever is more favorable. If a taxpayer buys shares in a fund, a substantial portion of the value of which is accounted for by unrealized appreciation, he may sustain a tax penalty on the distribution of capital gain dividends. The capital gain distribution will be taxable, but the per-share diminution of value caused by the distribution will not give rise to an immediate capital loss deduction. The capital loss deduction will be available when the loss is in fact realized by sale of the shares. The foregoing is illustrated by the following example:

38 See Union Trusteed Funds, Inc., 8 T.C. 1133 (1947).
39 Special Ruling, March 27, 1952, CCH 1952 STAND. FED. TAX REP. ¶ 6226.

> X buys shares in Y for $1000: thirty percent of Y's net asset value is accounted for by unrealized appreciation in portfolio holdings. Y realizes that appreciation (by sale of portfolio holdings) and distributes a capital gain dividend of $300 to X. X must pay a capital gain tax on the $300 dividend, although his shares are now worth only $700. But, if he were to sell those shares for $700 (the next day or several years later) he would deduct a $300 capital loss.

Under section 852(b)(3)(D), the individual shareholder is obliged to treat undistributed capital gains of which he has received written notice within forty-five days after the close of the taxable year of the investment company as though they had been distributed to him in his tax year in which the last day of the investment company's tax year falls. The foregoing statements are illustrated by the following example:

> Assume investment company X has a tax-accounting period ending on June 30 and that individual shareholder Y reports his tax liabilities on a calendar-year basis. Assume further that Y's share of X's capital transactions were as follows: long-term capital gain $50; long-term capital loss $20; short-term capital gain $10; short-term capital loss $20. On August 8, 1966, X mails Y a written notice of undistributed capital gain in the amount of $30. For his 1966 return (filed not later than April 15, 1967), Y reports a long-term capital gain of $20.

Carrying this example somewhat further, X is required by section 852(b)(3)(D)(ii) to pay five dollars in capital gain tax with respect to Y's share of the fund by no later than July 30, 1966, although X's tax return for its fiscal year 1966 is not due until September 15. In addition to reporting the twenty dollars of capital gain, Y will be entitled to a tax *credit* of five dollars under section 852(b)(3)(D)(ii) just as though that five dollars had been withheld from wages. In addition, under Section 852(b)(3)(D)(iii), Y will be entitled to step up his basis in the shares generating the capital gain by an amount equal to fifteen dollars divided by the number of shares involved. If realized but undistributed capital gains are distributed in a subsequent year, the shareholder does not treat them as income, but he is required to make a downward readjustment in the basis of his shares.

Finally, by virtue of section 852(b)(4), if a taxpayer who is required to recognize capital gains (on amounts which are either distributed or undistributed) sells the shares generating the gains before holding them thirty-one days (or in some cases thirty days), he is required to treat any loss sustained on sale as a long-term capital loss to the extent that he treated capital gain dividends as long-term capital gains. The effect of this rule is to offset any subsequent loss on sale against income taxable at the more favorable capital gain rates to the extent that he has treated capital gain dividends as long-term capital gains before applying such losses against income taxable at the ordinary rates.

Section 852(c) in effect provides that the accumulated earnings and profits of a regulated investment company may be reduced by the amount of any nondeductible capital loss, but that the current year's earnings and profits account may not be reduced by such a loss. It will suffice at this point to observe that the existence of a current or accumulated earnings and profits account surplus determines whether a corporate distribution shall be characterized as a dividend or as a return of capital to shareholders under section 316 of the Code.[40]

Consequences to Shareholder Upon Entry Into and Exit from a Fund

When an individual purchases shares of a fund, no taxable event occurs, but the price paid per share fixes the purchaser's basis which, subject to intervening adjustments, will be used to measure gain or loss on sale.

Until quite recently, it was assumed that an exchange of portfolio holdings for shares in a Centennial-type fund — one in which many holders of stock simultaneously exchange those shares for eighty percent or more of the shares of a fund — would qualify as a tax-free transfer under section 351(a) of the Code. Although the Service has repeatedly announced that it will not issue rulings on such transfers,[41] it apparently has not affirmatively acted to attach taxable consequences to such exchanges. Its position in this regard has been widely criticized,[42] and on July 14, 1966, it announced a proposed rule change which, if adopted, would deny tax-free treatment to Centennial exchanges.[43]

Section 852(d), added by the Revenue Act of 1964, resolves a problem that sometimes arises when a shareholder of a unit investment trust elects to redeem part or all of his shares. If, for example, a holder of a significant number of shares were to request the redemption of all his shares, the trust might have to sell a portion of its portfolio holdings (ordinarily, the shares of a single management investment company) to realize sufficient cash to redeem the shares.[44] If the shares sold by the trust have appreciated in value (which would usually be the case), the question would arise whether the portion of the payment to the redeeming shareholder attributable to the gain on the sale of portfolio holdings should be regarded as a "preference" dividend under section 562(d) of the Code. If so, the gain would be taxable to the company, and the payment to the redeeming shareholder could not be claimed by him as a dividends-paid deduction. As stated, section 852(d) resolves the problem with respect to unit investment trusts by prescribing that payments to the redeeming shareholder are not "preference" dividends, but the question is left open with respect to the far more significant management investment companies.[45]

40 The rule is illustrated in Treas. Reg. § 1.852-5 (1957), as amended, T.D. 6369, 1959-1 CUM. BULL. 173.

41 *E.g.*, Rev. Proc. 64-31, 1964-2 CUM. BULL. 947, 949.

42 See, *e.g.*, Chirelstein, *Tax Pooling and Tax Postponement — The Capital Exchange Funds*, 75 YALE L.J. 183 (1965); Goldman, *Warwick Fund Ruling Withdrawn; IRS Policy Questioned*, 19 J. TAXATION 197 (1963).

43 Proposed Treas. Reg. § 1.351-1(c), 31 Fed. Reg. 9549 (1966).

44 Under § 2(a)(31) of the ICA an issuer of redeemable shares, which could be either an open-end investment company or a unit investment trust, must stand ready to redeem its shares either in cash or in kind or a combination of the two. But if the issuer's prospectus has stated that the shares will be redeemed on demand in cash, the issuer will be obliged to do so, even though that course of action might require the sale of some appreciated portfolio holdings.

45 Foreign investment companies whose redemptions have exceeded sales since the Interest Equalization Tax (§§ 4911-20 of the Code) became effective in 1963 may be facing this problem.

Dividends-Received Exclusion for Shareholders

Section 116 of the Code allows a taxpayer to exclude from gross income up to one hundred dollars in dividend income received during a taxable year. When married taxpayers file a joint return, their return may exclude up to two hundred dollars in dividend income provided either that each spouse individually owns shares generating one hundred dollars of dividend income or that they hold shares in some form of joint ownership, which, under state law, gives each a right to the dividend income in proportion to his or her interest.

Within limitations, section 854 permits shareholders in investment companies to exclude from section 116 treatment both capital gain dividends and the portion, if any, of ordinary income dividends attributable to profits on trading in securities.

The limitation imposed by section 854 on the amount of dividends that shareholders may treat as within the coverage of section 116 affects only those investment companies that derived less than seventy-five percent of their income from dividends on portfolio securities of domestic corporations during a given year. If a company derives less than seventy-five percent of its income from dividends, then only the proportion of dividends paid to shareholders which equals the proportion of total income accounted for by dividends is eligible for the dividends exclusion.[46] For example, assume that an investment company having no short-term gains had a total income of $100,000, of which only $65,000 were accounted for by dividends and interest. Assume further that shareholder *X* received one hundred dollars in ordinary income dividends during the year. Sixty-five dollars would be eligible for the dividends-received exclusion. Assume the same facts, except that *X* received two hundred dollars in ordinary income dividends. One hundred dollars would be eligible for the dividends-received exclusion. Generally, the same rules apply under sections 243-46 (intercorporate-dividends deduction) with respect to corporations.

It was noted previously that Rev. Rul. 64-247[47] held that an amount recovered by an investment company in compromise settlement of an action brought against its former management adviser was gross income. It was observed at that point that the characterization of the recovery sum as gross income seemed to be inconsistent with the ruling's ultimate determination that the receipt of such income would not destroy the company's status as a regulated investment company under section 851(b)(2). Consistent with the assertion that the amount recovered was gross income, the Service further ruled that the dividends paid to shareholders should be excluded by shareholders under section 116 only to the limited extent provided by section 854, after taking the recovered sum into income and computing the proportion of total income accounted for by dividend and interest sources.

Under section 854(b)(2), the only portion of the dividends paid to shareholders otherwise eligible for section 116 treatment that may be treated as such is that which is so designated by the investment company in a written notice

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46 The dividends paid to shareholders by investment companies whose assets are concentrated in the securities of foreign issuers do not qualify for § 116 treatment.

47 1964-2 Cum. Bull. 179.

mailed to shareholders within forty-five days after the close of the company's taxable year.

Foreign Tax Credits

Under section 853, a regulated investment company that has more than fifty percent of the value of its assets at the end of its taxable year invested in securities of foreign corporations[48] and makes dividend payments to shareholders sufficient to qualify for pass-through treatment under section 852(a) may treat any foreign income taxes paid as though they had been paid in dividends to shareholders. Such amounts may be deducted as dividends rather than as taxes. The shareholders, in turn, treat their share of the foreign taxes as though it had been distributed as dividends and treat the portion of the dividend income generated by foreign holdings as though it were derived from sources outside the United States. Thus, they become eligible for the foreign tax credit of subchapter N, part III.[49] As usual, the investment company's intention to bring itself within section 853 must be announced to shareholders in writing *no later than* forty-five days after the close of its taxable year. The amount of gross income to be treated by shareholders as having been derived from sources outside the United States is limited by the amount so designated by the investment company's notice to shareholders within the forty-five-day notice period.

Taxation of Foreign Investment Companies

In 1954, the SEC adopted Rule 7d-1 under the Investment Company Act.[50] That rule provides for the registration of Canadian investment companies if the company, its officers, directors, investment advisor, principal underwriter and custodian contractually agreed to be bound by certain of the act's regulatory provisions.

Following the adoption of that SEC regulation, a miniature subchapter M for foreign investment companies was incorporated into the Revenue Code as sections 1246-48 by the Revenue Act of 1962.[51] With minor exceptions, the statutory scheme is similar to that applicable to domestic corporations under subchapter M. In summary, a foreign investment company is defined by section 1246(b)(1) as a foreign corporation that is registered with the SEC as an investment company and is owned, to an extent exceeding fifty percent, by Americans. Section 1246(b)(2) extends similar treatment to a few classes of nonregistered foreign investment companies. There is no requirement that the foreign investment company's portfolio holdings be concentrated in the shares of foreign corporations. Conceivably, such a company could invest exclusively in the shares of American corporations, but, as will be seen, one of the benefits available to such companies would thereby be lost.

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48 The term "foreign corporation" is defined by § 7701(a)(5) of the Code to mean a corporation that is not "domestic." "Domestic" is defined by § 7701(a)(4) to mean, in the case of corporations, those organized under the laws of a State, Territory or the United States.

49 INT. REV. CODE OF 1954, §§ 901-72.

50 17 C.F.R. § 270.7d-1 (1964).

51 INT. REV. CODE OF 1954, §§ 1246-48, added by 76 Stat. 1036-41 (1962).

As is the case with domestic investment companies whose portfolio holdings are concentrated in the shares of foreign corporations, the foreign investment company may elect to forego its own foreign tax credit and to pass that credit through to its shareholders. In order to elect that treatment, however, the foreign investment company, like its domestic counterpart, must have more than fifty percent of the value of its assets invested in foreign stock or securities.

Summary

It was noted in the opening remarks that subchapter M and related sections of the Code constitute an atypically complicated set of special-industry tax relief measures. Many of the provisions are relatively mechanical in nature and, once assimilated, give rise to few problems. Others have posed difficult questions of interpretation. In dealing with close questions, the Service has generally taken a liberal view. Consequently, there has been comparatively little litigation. The mutual-fund industry probably could not have grown to its present dimensions without benefit of the provisions under consideration. It may be that the paucity of litigation reflects a tacit concensus within the industry that the less said about subchapter M the better.