

MEMORANDUM

July 10, 1941

TO: The Commission
FROM: John H. Hollands
RE: Investment Company Taxation

Attached are copies of the following which I received yesterday from Mr. Schenker:

(1) A memorandum regarding investment company taxation. Except for certain minor revisions made by Mr. Schenker, this is the same memorandum as that which he discussed with the Commission on June 28. Judge Healy took a copy of the memorandum (not revised) with him on his vacation.

(2) Draft of a covering letter for use in transmitting the memorandum in response to any request which may be made by Congress.

JHH/dt

Memorandum Regarding Changes in Taxation

The Commission has recently completed its four year study of investment companies which culminated in the enactment on August 22, 1940 of the "Investment Company Act of 1940" providing for comprehensive supervision and regulation of these organizations. During the course of the study, the Commission's staff gave considerable attention to the problem of taxation of investment companies. Based upon these studies, the Commission has been for some time and is presently convinced that certain inequities and discriminations exist in respect of investment companies in the Internal Revenue Code.

The United States Senate Committee on Banking and Currency and House Interstate and Foreign Commerce Committee reports recognized that these "companies honestly and efficiently managed can serve a most useful purpose in extending to the public an opportunity to participate financially in the economic enterprise of the country". At the same time the committees recognized that diversified investment companies are faced with a serious problem of federal taxation which should receive prompt consideration. (76th Congress, 3rd Session, Senate Report No. 1775, p. 12 and House Report No. 2639, p. 10). The Senate Committee on Banking and Currency stated in its report:

"Representatives of the Securities and Exchange Commission in connection with the bill and members of the industry who appeared at the hearings called the attention of the subcommittee to the serious tax problem affecting investment companies. This problem has already been recognized by the Congress in the case of certain open-end management investment companies which receive special tax treatment under existing Federal revenue rules. The record before the committee indicates that the tax problem is very pressing with respect to closed-end management investment companies of the type classified in this bill as 'diversified'. If the bill is passed the committee believes that the tax problem of these companies should receive prompt consideration by the Congress."

The Internal Revenue Code of 1936 granted special tax treatment to a limited group of investment companies, the so-called “mutual investment companies” as defined in Section 361 of the Code. The only type of investment company which can qualify under that Section are the open-end companies whose security holders had the right of redemption, the right to compel investment companies to repurchase their securities at asset value. The Commission has always contended that any differentiation in tax treatment of investment companies which is predicated upon the presence or absence of the right of redemption is unsound and discriminatory. The Commission as a result of its comprehensive study is convinced that any preferential tax treatment which is granted only to investment companies whose shareholders have the right to compel the investment company to redeem their shares is unfair and discriminatory and that such discrimination has had and will continue to have very undesirable effects and consequences on many investors and on the investment company industry as a whole.

The record of the study, in our opinion, is conclusive, and the legislation regulating these institutions codifies this conclusion, that the basic distinction between investment companies should be predicated not upon the right of the shareholders to compel redemption of their shares but rather upon the investment policy of the company and the function it performs for its shareholders.

Some recognition of this unwarranted discrimination between open-end and closed-end companies is disclosed by the fact that in the Excess Profits Tax and Special Amortization Act of 1940, an exemption from the excess profits tax was granted not only to the mutual investment companies as defined in Section 361 of the Code but to all diversified management companies regardless of whether or not their stockholders had the right to compel redemption of their shares. This exemption from excess profits tax, although recognizing the principle of equality of

treatment of closed-end and open-end companies, did not solve the taxation problems of investment companies. The open-end companies are still the only management investment companies which receive some special treatment of normal income tax problems. The Commission believes that closed-end management companies of the diversified type as defined in the appendix hereto annexed should receive tax treatment which is comparable to that now granted to the mutual investment companies.

This study of investment companies by the Securities and Exchange Commission indicates that the typical shareholder in investment companies is one whose personal income tax under the present Internal Revenue Code would probably range from about 4.4% to 10%. This typical stockholder today pays a high price for his participation in diversified investment companies because of the present discrimination and duplication of income taxes. Such an individual investing directly would pay between 4.4% and 10% on dividends, interest and short-term capital gains; if he pools his funds in an investment company, not only will he pay this same tax on such income when distributed to him, but in addition he in effect bears the corporate tax of 3.6% (15% of 24%) on dividends received by the investment company and 24% on interest and short-term capital gains. On long-term capital gains the direct investor has the advantage of the "ageing" provisions of Section 117, reducing his tax by 33-1/3% or 50%. But if an individual participates in an investment company, the ageing provisions are inapplicable and he must bear a tax to the corporation at full rates on long-term capital gains as on other income. If the company distributes the long-term gains as dividends, the stockholder again pays the full rate on the receipt of such dividends; if the gains are not distributed to him they are nevertheless reflected in the advanced market price of his shares upon which he will pay further tax when he disposes of them. In addition, the investment company is subjected at the present time to the

capital stock tax and declared value excess-profits tax, a levy which is not made upon the direct investor.

The table below demonstrates graphically the extent of the tax burden to which the average closed-end diversified investment company stockholder is now subjected as compared with that of the direct investor. For purposes of this illustration it has been assumed that the tax rate applicable to the individual taxpayer is 8.8% (4% normal tax, 4% surtax, and defense tax); this may tend to be too high rather than too low, in the light of available statistics as to the value of the average holding in investment company securities.

Federal Income Tax Payable on \$1000 Realized Capital Gain:

(a) By individual investing his own funds

if held 18 months or less	8.8%	<u>\$ 88.00</u>
if held more than 18 months and not exceeding 24 months 66-2/3% of	8.8%	<u>\$ 58.67</u>
if held more than 24 months 50% of	8.8%	<u>\$ 44.00</u>

(b) By investment in closed-end diversified investment company:

full corporate tax on capital gains (1940 Act)	24%	<u>\$240.00</u>
full normal tax, surtax and defense tax on remaining \$760 if distributed as taxable dividend	8.8%	<u>\$ 66.88</u>
or: remainder of \$760 taxable at between 4.4% and 8.8%, depending on length of time security was held, if profit instead of being distributed, is reflected in price received upon sale of investment company security		<u>\$ 33.44</u> to <u>\$ 66.88</u>
Total tax		<u>\$273.44</u> <u>\$306.88</u>

Thus, a closed-end diversified investment company stockholder would pay a tax of between \$273.44 and \$306.88 upon a capital gain of \$1000 as compared with a tax of between \$44 and \$88 payable by a direct investor realizing similar gain.

In order to reduce somewhat the severity of this discrimination against the investment company stockholder, the following suggestions for amendment of the Internal Revenue Code are submitted. These proposed amendments are, in general, to be applicable in the case of investment companies (other than personal holding companies) of the diversified type as defined in the appendix hereto annexed.

(1) Extend the “Ageing” provisions of Section 117(b) to these companies, so that only 50% of a capital gain or loss on the sale of a security held for more than 24 months, or 66-2/3% of a capital gain or loss on the sale of a security held for more than 18 months but not more than 24 months, shall be taken into account in computing net income. Under the rates now in effect this proposal would provide a corporate tax of 12% (50% of 24%) on gains on securities held for more than 24 months, which in itself would probably represent a much higher rate of tax than, in the light of the aforementioned studies of the Securities and Exchange Commission, would be payable on direct investment by the typical stockholder. The rate would be almost as high as the maximum tax now payable by an individual on such gains. In addition, if not distributed as a dividend the gain would be reflected in the market price of the stock of the company and hence would still affect the tax payable by the stockholder when he subsequently sells his stock. Or if the gain is distributed to the stockholder it would be taxable as a dividend to him.

Congress has long recognized that such gains, accruing over an extended period, should not be made to bear the full rate of tax in the hands of the individual investor in the year in which they are realized; to provide otherwise in the case of diversified investment companies serves only to discriminate against the utilization by the public of the valuable investment services which such companies offer. By “ageing” losses as well as gains these companies will not find it as necessary to preserve unrealized losses to offset future long-term capital gains, a tendency which has become almost essential in view of the present high corporate taxes upon capital gains and which should be removed so far as possible as an item of consideration in determining investment policy of these companies.

This amendment would probably represent no immediate tax benefit to the companies since most of them have on hand securities which could be sold to realize substantial long-term losses to offset long-term gains. Nevertheless it is believed that the proposal is sound in principle and over a period of years would serve to remove one of the major tax differentials now existing between investment company participation and direct investment.

(2) In the case of diversified investment companies the corporate tax shall be imposed upon net income (after ageing of long-term gains and losses) reduced by the amount of the dividends paid by the company during the year, but without the benefit of the dividends received credit; provided that the companies distribute in the form of taxable dividends 90% or more of their ordinary net income, exclusive of capital gains and losses. After all other net income of the taxable year has been distributed, any distribution out of net long-term capital gain realized by the corporation in the taxable year shall be taxed to the shareholders as long-term capital gain.

This proposal is designed to relieve the investment company of the corporate income tax to the extent that it distributes its current income to its stockholders and accordingly results in tax to them upon its receipt; such relief being allowed only where the company so distributes 90% of its ordinary net income. One of the principal tax burdens now suffered by the investment company and its stockholders is double taxation of the same economic income, once in the corporation, and again on current distribution to stockholders. This proposal would eliminate to some extent this unfortunate duplication of tax. Under it the Government would still collect tax upon receipt of dividends by the stockholder in the same year in which the income is derived by the corporation. With respect to distributed interest, dividends and short-term gains the same tax would be paid as though the stockholder had invested directly. With respect to long-term capital gains, the corporation would have to distribute 50% or 66-2/3% of such gains in order to

eliminate its tax thereon (since they would be “aged” as suggested in item (1); the stockholders would pay tax on the amounts distributed to them as a dividend in respect of such capital gains, resulting in payment of tax upon 50% or 66-2/3% of the long-term gain as in the case of a stockholder investing directly. To the extent that the income may not be distributed by the investment company it will bear its appropriate tax to the company.

It may be noted that the present proposal does not take into account either capital gains or losses in determining the amount required to be distributed in order to qualify under this method of taxation. Requiring an investment company to distribute its capital gains would deprive it of proper balance against the losses which will inevitably come in periods of falling prices. Failure to retain gains in order to offset future losses will inevitably lead to shrinkage of these companies and accordingly reduce the opportunity for diversification and increase the effective cost of operation to the individual shareholder. Capital gains and losses in investment companies merely reflect the changing price level as the companies find it advisable to shift from one security to another; they represent no real operating profit of the type which should be distributed to the stockholder. Likewise capital losses should not affect the amount to be distributed.

It may also be noted that many diversified investment companies which have senior securities outstanding will not be in a position to avail themselves of this method of taxation because dividend restrictions in their charters or indentures, or prudent management required to preserve the security of the senior securities, will make it impossible for them to distribute the requisite amounts. Only those companies which have no senior securities and only a limited number of companies having senior securities will be able to qualify for this tax treatment.

However, in the event that a diversified investment company is in a position where it is deemed advisable to distribute net long-term capital gain realized by it during the taxable year, it

is proposed that such distributions be treated as long-term capital gains when received by the shareholders. The amounts so distributed would thus be included in income of the shareholders in their entirety but would be subject to the alternative taxes provided in Section 117(c) of the Code. This would have the effect of making net long-term capital gain realized by a diversified investment company and distributed by it to its shareholders during the taxable year subject to tax in a manner comparable to that applicable to long-term capital gains realized by the direct investor. Distributions would be deemed to have been made out of net long-term capital gain of the company only after the distributions during the year have amended the net income of the company exclusive of such gain.

(3) Amend Section 102, imposing surtax on companies improperly accumulating surplus, so as to exclude long-term capital gains from “net income” in computing “Section 102 net income” of a diversified investment company. The indefinite and uncertain application of Section 102 has caused a serious question with respect to the necessity for distribution by investment companies of their long-term capital gains. For the reasons mentioned above, the retention of such gains is generally deemed to be essential to the proper operation of investment companies in order to provide for inevitable periods of capital loss. It would seem inconceivable that under the rates now in effect any individual would seek to avoid surtaxes by organizing or participating in a public investment company for the purpose of saving a maximum tax of 22% on long-term capital gains while suffering a 24% corporate rate on such gains. Nevertheless, the statute creates a presumption of the existence of purpose to avoid surtax in the case of a mere holding or investment company, a phrase which it may possibly be argued includes public diversified investment companies. Determination of the “reasonable needs of the business” is particularly difficult in the case of investment companies because while as above mentioned it is

sound investment management policy to retain capital gains, it is obviously impossible to prove a necessity for retaining any specific dollar amount of gains. And while it appears clear that public diversified investment companies afford no opportunity to effect tax savings on long-term gains, it might be argued that after the gains have been realized and the corporate tax incurred, a desire to avoid surtax to the stockholder motivated the decision to retain rather than distribute the gains.

It is believed that the risk of Section 102 being applicable to long-term capital gains of public diversified investment companies is very insubstantial. However, the amount of Section 102 tax that would be involved if one of these companies retained a large amount of long-term capital gains realized during an advancing price period might be of such magnitude as to force the directors to distribute such gains in order to eliminate the risk of tax liability however slight it may be. While the amount of net long-term capital gains realized in recent years has not been such as to create a severe problem in this connection it may be of considerable potential importance in the future and any doubt as to the applicability of Section 102 to such gains should be removed by statutory amendment.

(4) Exempt diversified investment companies from capital stock tax and declared value excess-profits tax. The present capital stock tax and declared value excess-profits tax is a material burden in the case of these companies. While the tax is not large in respect of dividends received by the company in view of the 85% credit allowed for excess-profits tax purposes, the burden of the tax is severe in respect of capital gains. It is obviously impossible for a company to predict with reasonable certainty over a three-year period the course of price levels and the necessity for switching investments. Accordingly, it becomes necessary for an investment company to declare an extremely high value in order to protect itself against incurring a substantial excess-profits tax in the event of a rising market. Such problems do not exist in the

case of industrial or mercantile companies where realization of long-term capital gains rarely occurs in substantial amounts.

As a pooling of the resources of many individuals and as a medium for intelligent and discriminating investment on their behalf, these companies are not engaged in the type of corporate activity which excess-profits taxation was designed to cover. If the operating companies whose stocks are owned by the investment company make substantial profits they will be subjected to these taxes. If the individual had invested directly in the stocks of the operating companies there would be no duplication of excess-profits taxation. Both the direct investor and the investment company stockholder should bear his burden of excess-profits taxation through the imposition of the tax upon the operating industrial and mercantile companies and there should be no discrimination against the investment company stockholder by imposing upon him duplicate taxation not exacted of the direct investor.

The logic and necessity of exempting these companies from excess-profits taxation has been expressly recognized in the Excess Profits Tax Act of 1940 wherein diversified investment companies have been exempted under Section 727(d) of the Act. The reasons for exempting these companies from the excess profits tax apply with even greater force under the capital stock and declared value excess-profits taxes for the latter taxes, unlike the 1940 excess profits tax, take into account long-term capital gains which create the most serious problem in this connection.

The foregoing proposals would, at least in some measure, serve to reduce the present burdensome taxation of the diversified investment company and its stockholders.

Annexed hereto as appendix A is a draft of the provisions which if included in the Revenue Bill of 1941 would accomplish the changes recommended in this memorandum.

SUPPLEMENT T - DIVERSIFIED INVESTMENT COMPANIES

Sec. 401. Tax on Diversified Investment Companies.

(a) Definition. - As used in this chapter the term “diversified investment company” means any domestic corporation (other than a personal holding company as defined in section 501) which under the Investment Company Act of 1940 (1) at all times during the taxable year is registered as a diversified company, or (2) at all times during the taxable year is registered as a management company and does not have more than 25 percent of the value of its total assets represented by securities of one or more issuers (other than other registered investment companies) controlled by such company and directly or indirectly engaged in or conducting similar types of business, or (3) is a corporation in the securities of which a registered investment company is authorized to invest in accordance with the provisions of section 12(e) of that Act. For the purposes of this definition, if a company is registered as aforesaid before July 1, 1941, it shall be considered as so registered at all times prior to the date of such registration.

(b) Long-term Capital Gain or Loss. -

(1) For the purposes of Section 117(b) a diversified investment company shall not be considered a corporation

(2) The “section 102 net income” of a diversified investment company shall be computed without inclusion of net long-term capital gain.

(c) A diversified investment company shall not be subject to taxation under subchapter B of chapter 2 or under chapter 6.

(d) In the case of a diversified investment company (other than a mutual investment company as defined in section 361) which during the taxable year distributes to its shareholders

as taxable dividends an amount not less than 90% of its net income, exclusive of gain or loss upon the sale or exchange of capital assets, its normal-tax net income shall mean its adjusted net income, computed without the net operating loss deduction provided in Section 23 (s), minus the basic surtax credit computed under Section 27 (b) without the application of paragraphs (2) and (3).

Sec. 402. Capital Dividends.

(a) Definition. - As used in this chapter the term “capital dividend” means any dividend paid by a diversified investment company to its shareholders, whether in money or in other property, out of the net long-term capital gain of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the long-term capital gains or losses at the time the distribution was made.

(b) Source of dividends. - For the purposes of this section the dividends paid by a diversified investment company during any taxable year in any amount in excess of the net income of the taxable year, exclusive of the net long-term capital gain, are paid out of the net long-term capital gain of the taxable year to the extent thereof.

(c) Income of shareholders. - A capital dividend received by a shareholder of a diversified investment company shall be included in its entirety in the income of the shareholder as long-term capital gain.

Dear Sir:

We are pleased to answer your request for an expression of opinion by the Commission on the subject of taxation of investment companies. As you know, the Commission has completed its four year detailed study of investment companies which culminated in the enactment on August 22, 1940 of the "Investment Company Act of 1940" providing for the comprehensive supervision and regulation of these organizations. During the course of this study the Commission gave considerable attention to the problem of taxation of investment companies. On previous occasions, the Commission strongly indicated to Congressional committees and to the Treasury officials that certain inequities and discriminations existed in the Internal Revenue Code in respect of investment companies. It was manifest to the Commission that the very existence of these organizations in this country was dependent upon the elimination of these inequities and upon the adoption of a different method of taxation of these companies. If these companies are to continue, the penalties which its shareholders suffer under existing tax legislation must, in the opinion of the Commission, be removed.

We are herewith transmitting to you a memorandum discussing the unsound aspects of the present tax law in respect of investment companies, together with a detailed discussion of the changes suggested by the Commission. We are also sending annexed to that memorandum, a draft of the statutory language which, if incorporated in the new tax law, would effectuate the recommendations of the Commission.