Oil and Water: Mixing Taxable and Tax-Exempt Shareholders in Mutual Funds

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As of 2012, roughly 23% of U.S. households' assets and 50% of retirement assets are invested in mutual funds, thus making mutual funds one of the most important investment vehicles for U.S. households. The federal taxation of mutual funds and mutual fund shareholders has played a vital role in the development of mutual funds and their appeal to U.S. investors.

Despite the significant amount of mutual fund assets held in retirement accounts, there has been very little analysis of the issues that arise when taxable and tax-exempt shareholders invest together in the same mutual fund. A substantial body of research shows that managers are attuned to the tax consequences of their investment activities, but only very recently have researchers begun to explore how the presence of tax-exempt investors affects managers' investment strategies.

The current tax regime governing mutual funds imposes tax externalities on both taxable and tax-exempt shareholders. When tax-exempt shareholders predominate, fund managers focus less on managing fund tax liability and thereby generate higher taxes and lower after-tax returns for taxable shareholders. When taxable shareholders hold a significant portion of a mutual fund's assets, the fund manager, focusing on minimizing fund taxable income, may undertake trades that reduce fund income but do not add economic value. These trades impose costs on all shareholders but benefit only taxable shareholders.

This Article considers various options to mitigate these costs, such as requiring funds to disclose the percentage of tax-exempt investors, adopting principles from partnership taxation to better match taxable and economic income, and prohibiting a fund from being offered to both taxable and tax-exempt investors.

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This Article concludes that tax externalities resulting from taxable and tax-exempt investment in the same mutual fund are unavoidable absent substantial changes to the basic architecture of mutual fund taxation. Because such changes seem unlikely and would create other issues, this Article suggests revising the tax law to permit the creation of a special class of mutual fund, the "Retirement Mutual Fund," solely for retirement accounts. A Retirement Mutual Fund would be subject to an alternative tax regime that would mitigate tax externalities for both tax-exempt and taxable shareholders.

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INTRODUCTION

Mutual funds are one of the most important investment assets of U.S. individuals, accounting for 23% of U.S. households' financial assets at the end of 2011.[1] In fact, there are more mutual funds than companies listed on the major U.S. exchanges.[2] Mutual funds account for over 55% of the assets in defined contribution plans, such as 401(k) and 403(b) plans, and 45% of assets in individual retirement accounts ("IRAs").[3]

Mutual funds offer many advantages to investors—especially investors with limited capital—such as diversification, daily liquidity, and the opportunity to obtain economic exposure to asset classes that would otherwise be difficult for an ordinary investor to obtain directly.[4] Also, when an investor acquires shares of an actively managed mutual fund, she gains exposure to the possible alpha-enhancing skills of the fund manager.[5]

The current mutual fund tax regime was established in the 1930s and 1940s. If an entity satisfies the requirements to be treated as a regulated investment company ("RIC"),[6] it avoids entity-level tax by distributing its income.[7] A fund's shareholders are taxed on the fund's income under a quasi pass-through system in which most income distributed to a fund's shareholders retains the same character it had in the hands of the fund.

The current RIC tax regime was forged in an era when there were no self-directed, defined contribution plans, and many of its requirements are irrelevant for tax-exempt shareholders. Nevertheless, tax-exempt

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1. INV. CO. INST., 2012 INVESTMENT COMPANY FACTBOOK 10 fig.1.2 (2012).

2. For 2011, there were 16,506 investment companies, consisting of 8684 mutual funds, 634 closed-end funds, 1166 Exchanged Traded Funds ("ETFs"), and 6022 Unit Investment Trusts ("UITs"). *Id.* at 18 fig.1.11. The number of listings in 2008 on the principal U.S. exchanges—NASDAQ, New York Stock Exchange, and American Stock Exchange—totaled 5401. David Weild & Edward Kim, *A Wake-up Call for America*, CAP. MARKETS SERIES (Grant Thornton, London, U.K.), Nov. 2009, at 1.

3. INV. CO. INST., *supra* note 1, at 11 fig.1.4.

4. Examples of such assets include commodities and foreign stock and bonds.

5. In theory, a professional fund manager may be able to avoid some of the behavioral biases of unsophisticated investors. Even if that is so, managers may not be able to generate sufficient alpha to overcome their expenses to provide superior returns. *See, e.g.*, Kenneth R. French, *The Cost of Active Investing*, 63 J. FIN. 1537, 1537–39 (2008).

6. Subchapter M (sections 851 through 860G) of the Internal Revenue Code ("the Code") addresses the taxation of RICs, real estate investment trusts ("REITs"), and real estate mortgage investment conduits ("REMICs"). *See* I.R.C. §§ 851–860G (2012).

7. *See id.* § 852 (describing taxation of RICs and their shareholders); *id.* § 854 (outlining treatment of dividend received from RICs). For a discussion of the computation of a mutual fund's investment company taxable income, see *infra* Part II.C.

shareholders bear their share of many direct and indirect costs imposed by the RIC tax regime. For example, a distribution from a RIC can thus be characterized in the hands of a RIC shareholder as an ordinary dividend, qualified dividend, net capital gain, or tax-exempt interest.[8] Determining and assigning these amounts to fund shareholders requires sophisticated tax compliance systems. Tax-exempt shareholders, such as IRAs and 401(k) and 403(b) plans, are indifferent to the character of RIC distributions, but they bear their share of a fund's tax compliance costs.

Another example is the cost of compliance with the RIC distribution requirement—a fundamental component of the RIC tax regime. To qualify as a RIC, a company must generally distribute annually the sum of 90% of its taxable income and tax-exempt interest.[9] To the extent that a RIC does not distribute its investment income, it is subject to entity-level tax,[10] and if it fails to distribute 98% of its ordinary income and capital gain net income, it is subject to a nondeductible 4% excise tax.[11] Although one of the purported goals of the distribution requirement is to ensure that shareholders will have sufficient cash to satisfy their tax liability, this concern is entirely irrelevant for tax-exempt shareholders. Yet, they still bear their share of the fund's distribution costs.

In addition to the tax compliance and distribution costs, tax-exempt shareholders may also bear trading costs incurred by managers undertaking trades to lower a fund's (and shareholders') income. The basic story is as follows: A taxable shareholder is concerned with a fund's after-tax returns. A fund manager is concerned with generating returns in order to increase assets under management ("AUM") as manager compensation is generally based on AUM, and investors seek funds with higher returns. Taxable investors, however, unlike tax-exempt investors, generally look to after-tax returns. Consequently, a manager that aims to maximize after-tax returns so as to increase AUM may undertake trades to lower a fund's taxable income that have no effect on a fund's return.[12] For taxable shareholders, a trade that lowers a RIC's taxable income but is not expected to generate a positive risk-

8. *See infra* Part II.D.

9. I.R.C. § 852(a)(1); *see infra* Part II.C.

10. I.R.C. §§ 852(b)(1)–(2). A RIC is technically subject to tax on its investment company taxable income and its net capital gains, but these amounts are reduced by dividends paid by the RIC. Consequently, a RIC that distributes all of its investment company taxable income and net capital gains is not subject to entity-level tax. *See infra* Part II.C.

11. *See* I.R.C. § 4982. This issue is discussed *infra* in Part II.B.

12. For example, a manager may realize losses to offset realized gains, or if a fund has a capital loss carryforward, a manager may realize capital gains.

adjusted return can still be beneficial. These tax-motivated trades, however, generate costs that are borne by all shareholders but benefit only taxable shareholders. On the other hand, the taxes of taxable investors will be accelerated, and they will have smaller after-tax accumulations if managers prioritize the interests of tax-exempt investors.

Over the last two decades, the percentage and amount of fund assets held by tax-exempt investors has soared. By the end of 2011, about 26% of the $17.9 trillion of U.S. retirement assets were invested in mutual funds, and this amount represented approximately 40% of the total assets of U.S. RICs.[13] Among a large sample of equity funds from 1997–2010, tax-exempt assets constituted about 32% of the total on a weighted-average basis.[14] As the proportion of tax-exempt assets increases, it appears that managers become less concerned with minimizing fund taxable income and distributions. In such funds, the taxes of *taxable* investors will be accelerated, and they will have smaller after-tax accumulations. The increasing presence of tax-exempt investors thus can cause managers to take actions that harm *taxable* investors.

This Article explores issues that arise when taxable and tax-exempt shareholders invest in the same RIC. Parts I and II examine the historical development and contours of the current RIC tax regime. Part III briefly describes the development of self-directed, tax-exempt retirement plans such as IRAs and 401(k) plans and how RICs have become the most important investment vehicles for such plans. Part IV next explores the cost of RIC taxes, how the presence of tax-exempt investors may make managers less attuned to the tax consequences of their investment decisions and thereby reduce the after-tax accumulations of taxable investors, and how certain aspects of the RIC tax regime may create incentives for managers to undertake actions that generate deadweight costs that can harm tax-exempt investors. At a minimum, investors and fiduciaries should find this analysis useful in deciding which funds to invest in or offer to beneficiaries.

Part V concludes by examining several potential policy responses to mitigate these costs. These responses include requiring funds to disclose the percentage of tax-exempt AUM, prohibiting co-investment

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13. INV. CO. INST., *supra* note 1, at 124.

14. Clemens Sialm & Laura Starks, *Mutual Fund Tax Clienteles*, 67 J. FIN. 1397, 1402 (2012). On an equal-weighted basis, the proportion of tax-exempt assets was 25%. This suggests that larger funds had a greater proportion of tax-exempt assets. *See id.* (highlighting the distribution of mutual fund assets). Importantly, assets of IRAs, which represent about 50% of retirement assets in mutual funds, were not included in this study. *Id.* at 1401 n.9.

by taxable and tax-exempt shareholders, and adopting principles from partnership taxation to better match taxable and economic income.

Finally, this Article considers and suggests that Congress should create a new class of mutual funds designed solely for tax-exempt investors, the "Retirement Mutual Fund," which would be free of many of the expensive tax burdens that affect only taxable investors and would ameliorate the conflicts that currently arise when taxable and tax-exempt shareholders invest in the same fund.

I. TAXES AND THE GENESIS OF THE MODERN MUTUAL FUND

Federal tax laws have played an enormous role in the development of mutual funds. Without the accommodating boundaries of the predecessor (and current) provisions of Subchapter M,[15] it is highly unlikely that mutual funds would have witnessed the same spectacular growth over the last eighty years.[16] These rules, however, were largely developed before the creation of self-directed retirement accounts and therefore focus exclusively on issues of taxable shareholders.

Investment companies pool resources from multiple investors to invest in diversified portfolios of stock or securities of other companies. They first rose to prominence in the United States in the 1920s when the U.S. stock market boomed.[17] During that period, all investment companies operated as closed-end companies. A closed-end company issues shares to investors and invests the shareholder-provided capital in stocks and securities. To liquidate an investment in a closed-end company, a shareholder generally must sell his shares to a third-party purchaser. Although the price a buyer would theoretically pay for a share of a closed-end fund should be equal to the fund's per share net asset value ("NAV"), the share price of closed-end funds is often traded at significant premiums or discounts to NAV.[18]

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15. The tax rules for mutual funds are found in sections 851 through 855, which are Part I of Subchapter M of the Internal Revenue Code. I.R.C. §§ 851–855.

16. Assets of U.S. mutual funds have grown from $450 million in 1940 to nearly $12 trillion in 2011 (including exchanged-traded funds and unit investment trusts). INV. CO. INST., *supra* note 1, at 134 tbl.1.

17. SEC. & EXCH. COMM'N, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 75-707, pt. 1, at 56–108 (1939).

18. MATTHEW P. FINK, THE RISE OF MUTUAL FUNDS: AN INSIDER'S VIEW 9–10 (2008); *see* H.R. DOC. NO. 75-707, pt. 2, at 322. The existence of premiums and discounts in closed-end funds continues today, and there is still no consensus among financial economists as to the causes. *See, e.g.*, Kenneth J. Boudreaux, *Discounts and Premiums on Closed-end Mutual Funds: A Study in Valuation*, 28 J. FIN. 515, 515–16 (1973) (discussing the most common explanations); Charles Lee et al., *Anomalies: Closed End Mutual Funds*, 4 J. ECON. PERSP. 153, 154–55 (1990) (noting that the pricing of closed-end funds presents several questions). The existence of closed-end fund premiums and discounts and the inability to trade open-end funds at intraday prices

The first open-end mutual fund in the United States, the Massachusetts Investors Trust, appeared in 1924.[19] The defining characteristics of an open-end fund are an investor's right to demand redemption of his shares from the mutual fund based on the fund's NAV and the continuous offering of new shares at NAV by the fund.[20] The creation of open-end funds was intended to mitigate some of the perceived deficiencies of the closed-end company such as shares trading at a discount to NAV and the lack of liquidity.[21]

During the 1920s and 1930s, closed-end funds dominated open-end funds. In 1929, for example, assets of open-end funds comprised only 2% of the assets of all investment companies.[22] Most of the remaining assets were held by closed-end funds.[23]

Prior to 1935, the federal tax regime imposed relatively low costs on closed-end and open-end funds.[24] Closed-end funds and other investment entities organized as corporations did not pay tax on dividends from portfolio stock because intercompany dividends were exempt from income tax in the hands of corporate shareholders.[25] When an investment company paid a dividend to a shareholder, the dividend was taxed like a dividend from any corporation. At that time, dividends received by individuals were exempt from the "normal" income tax but were subject to the "surtax" rate.[26] Consequently,

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helped stimulate the creation of ETFs in the 1990s.

19. FINK, *supra* note 18, at 11.

20. The Massachusetts Investors Trust ("MIT") charged a redemption fee of $2 per share. A 1924 MIT offering circular shows an issue price of $52.50 per share. A redemption fee of $2 would have been approximately 4% of the issue price. *Id.* at 12; *see* H.R. DOC. NO. 75-707, pt. 1, at 101–02.

21. *See* FINK, *supra* note 18, at 13–14.

22. H.R. DOC. NO. 75-707, pt. 2, at 27.

23. *Id.* The total of all investment company assets as of December 31, 1929 was $7.1 billion: open-end funds had $140 million of assets and closed-end funds, including management investment-holding companies, had $5.52 billion or 77%; the remaining assets were held by fixed investment trusts (trusts holding a fixed portfolio of assets), face amount installment certificate companies, and common trust funds. *Id.*

24. The effect of foreign, state and local, or transfer taxes on the development of mutual funds is beyond the scope of this Article. It is interesting to note, however, that the heading of the 1924 MIT offering circular reads "Tax Exempt in Massachusetts." The circular also touted the benefit of investing in MIT as opposed to holding shares directly in order to avoid state inheritance taxes. *See* FINK, *supra* note 18, at 12.

25. *See* Revenue Act of 1934, ch. 277, § 23(p), 48 Stat. 680, 690–91 (allowing corporation deduction against net income for dividends from domestic corporations).

26. Under section 25(a)(1) of the Revenue Act of 1934, individuals were permitted credits against their net income for purposes of the normal tax (but not surtax) for dividends from U.S. corporations. The surtax applied to taxable incomes in excess of $4000 (approximately $65,000 in 2010 dollars) was levied at a rate beginning at 4% and rising to 59% for taxable incomes in excess of $1,000,000. *See id.* § 12(b) (listing rates of surtax).

whether an investor held stocks directly or indirectly through an investment company, dividends paid by the underlying companies would be subject to only one shareholder-level tax. Although interest and capital gains earned by an investment company were subject to corporate tax, closed-end funds often issued debt, and the interest paid on such debt reduced a fund's taxable income. Also, many investment companies had losses or minimal gains because of the decline in stock prices from 1929 through 1933.[27]

Investment companies organized as business trusts initially took the position that they would be subject to tax as trusts rather than associations, which are taxed liked corporations. If an investment company were taxed as a trust, it could avoid entity-level taxes by paying out the trust's income,[28] and thus trust beneficiaries would avoid any entity-level tax. Until 1935, there was some uncertainty as to whether investment companies organized as trusts would be taxable as trusts or corporations. The Supreme Court settled this issue in *Morrissey v. Commissioner*, which upheld Treasury regulations classifying operating trusts as associations taxable as corporations.[29] Under these regulations, investment companies would be treated as operating trusts because their selection of investments or active management of portfolio companies would be treated as a trade or business.

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27. Capital losses could offset capital gains plus $2000 of other income. Revenue Act of 1936, ch. 689, § 117(d), 49 Stat. 1648, 1692; *Revision of Revenue Laws Before the H. Comm. on Ways and Means*, 75th Cong. 854–57 (1938) (statement of William T. Gardiner, Chairman, Incorporated Investors) (stating that corporate income tax is not a real burden because of availability of capital losses to offset realized capital gains). The potential conflicts between senior and junior securities holders "compelled" open-end funds to operate with only a single class of shares or interests. H.R. DOC. NO. 75-707, pt.1, at 101. The amount of leverage employed by closed-end funds was not insubstantial. According to the Securities and Exchange Commission ("SEC"), in 1929, debt and preferred stock represented about 60% of the total capital and liabilities of leveraged closed-end funds. For 1930–1934, the aggregate common equity of these funds was actually negative. *Id.* pt. 2, at 140 tbl.33. There were non-leveraged closed-end funds, although they were fewer in number and had fewer assets than the levered closed-end funds. For example, in 1929, there were ninety-one leveraged funds with total AUM of $1.3 trillion, compared to thirty-two unleveraged funds with total AUM of $318 million. *Id.* pt. 2, at 138 tbl.32.

28. *See* Revenue Act of 1934 § 162(b) (allowing a trust to deduct amounts paid to beneficiaries).

29. 296 U.S. 344 (1935). A trust that merely held a *fixed* portfolio of securities for its beneficiaries and distributed the income from the portfolio but could not vary the composition of the portfolio would not be taxed as an "association." This distinction survives in the current entity classification regulations. *See* Treas. Reg. § 301.7701-4(c)(1) (2013) (defining investment trusts).

A. The Revenue Acts of 1935 and 1936

In 1935, at President Roosevelt's behest, Congress modified the taxation of intercompany dividends by providing for a corporate dividends received deduction of 90%—that is, 10% of the dividends received by a corporation would be subject to corporate tax.[30]

Although Roosevelt had proposed exempting investment companies from the new tax on intercompany dividends, the final legislation did not provide for any specific relief for investment companies, and the corporate tax rate was raised from 13.75% to 15%. Consequently, investment company shareholders now bore an additional level of corporate tax on dividends from portfolio companies in excess of the taxes to which they would have been subject had they directly owned the stock of the portfolio companies. One mutual fund historian stated that investment companies feared being taxed out of existence.[31] This seems to be a bit of hyperbole as the maximum effective tax rate on dividends with the 90% dividends received deduction was only 1.5%.[32] In any case, shareholders of investment companies, including those organized as trusts, now bore an additional level of corporate tax on dividends from portfolio companies that they would not have if they invested directly. Also, because of stock market gains in the mid-1930s, the corporate tax on capital gains was now economically meaningful. The entity-level fiscal burden, however, would soon be alleviated.

To provide relief for investment company shareholders from entity-level taxation, Congress enacted as part of the Revenue Act of 1936 ("the '36 Act"), the precursor to the current Subchapter M.[33] The '36

30. Revenue Act of 1935, ch. 829, § 102(h), 49 Stat. 1014, 1016 (amending section 23(p) of the Revenue Act of 1934, which permitted deduction for the amount of any dividends received by a corporation in computing corporate taxable income). There was concern that the use of controlled multiple corporations could thwart the new graduated corporate tax rates enacted simultaneously with the reduced dividends received deduction. *Revenue Act of 1935: Hearing on H.R. 8974 Before the S. Comm. on Fin.*, 74th Cong. 223–24 (1935) (statement of Robert Jackson, Assistant General Counsel, Treasury Department). In addition, there was concern that holding company structures were being used to avoid tax on the consolidated income of the groups. Roy G. Blakey & Gladys C. Blakey, *Revenue Act of 1935*, 25 AM. ECON. REV. 673, 683–84 (1935).

31. FINK, *supra* note 18, at 26.

32. The Revenue Act of 1935 amended corporate income tax rates so that the highest corporate tax rate was 15%. Revenue Act of 1935 § 102(a). With a 90% dividend received deduction, only 10% of any dividend is subject to tax with a resulting effective tax rate on dividends of 1.5%—10% of 15% is 1.5%.

33. The behind-the-scenes actions of the representatives of open-end funds are engagingly detailed in Natalie R. Grow, The "Boston-Type Open-End Fund"—Development of a National Financial Institution: 1929–1940 (Apr. 30, 1977) (unpublished Ph.D. dissertation, Harvard University) (on file with author).

Act did not provide an outright income tax exemption for investment companies. Instead, tax exemption for a mutual investment company was predicated on the company deriving at least 95% of its income from passive income—such as dividends, interest, gains from stock and securities—and distributing at least 90% of its net income as taxable dividends.[34] In addition, an investment company could only invest up to 5% of its gross assets (based on historical cost) in the stock or securities of any one corporation (or government or political subdivision) and could not own more than 10% of the outstanding stock or securities (or both) of any one corporation.[35] Any income retained by an investment company, however, would be subject to corporate income tax. Finally, an investment company had to offer shareholders the right to redeem their shares at a value approximating NAV.[36]

The diversification requirement imposed by the '36 Act appears to have had various goals, and it has since remained a pillar of fund qualification both under the Internal Revenue Code and under the Investment Company Act of 1940.[37] First, a diversified portfolio is generally less risky than an undiversified portfolio. Thus, holding a portfolio of stocks is generally less risky than holding one, two, or a handful of stocks.[38] The basic intuition is that an individual company is subject both to idiosyncratic risk—for example, a fire at a factory—and to general market risks—for example, a decline in demand due to a recession. By increasing the number of companies in a portfolio, an investor lessens the effects of idiosyncratic risks, but still remains subject to market risk.[39] Another goal of the diversification requirement

34. To qualify as a mutual investment company, a corporation (including an investment trust) had to be organized for the purpose of investing in stock or securities, derive 95% or more of its gross income as passive income, derive less than 30% of its gross income from stock or securities held less than six months, and distribute annually 90% or more of its net income as taxable dividends. Revenue Act of 1936, ch. 689, § 48(e)(1), 49 Stat. 1648, 1669.

35. *Id.* § 48(e)(2). The Revenue Act of 1936 also limited the amount of debt an investment company could issue to 10% of its gross assets (based on historical cost). *Id.*

36. *Id.* § 48(e)(1)(E). A fund could impose a discount of up to 3%. *Id.*

37. *See infra* Part I.B (briefly describing the Investment Company Act of 1940).

38. *See, e.g.*, Meir Statman, *How Many Stocks Make a Diversified Portfolio?*, 22 J. FIN. & QUANTITATIVE ANALYSIS 353, 362 (1987) (showing that a well-diversified portfolio requires at least thirty to forty stocks).

39. Correlation describes the relationship between stock returns of different companies and ranges from 1 to -1, with a correlation of 1 representing a perfect positive relationship and a correlation of -1 representing perfect decreasing linear relationship. Under standard portfolio theory, provided that the correlation of the returns of the assets of a portfolio are less than 1, the standard deviation (risk) of a portfolio of assets is lower than the weighted average of the standard deviation of the portfolio assets, but the expected return of a portfolio of assets is equal to the weighted average of the expected returns of the assets. Consequently, combining uncorrelated assets leads to reduction in risk in the portfolio without a corresponding reduction in

was to prevent mutual funds from becoming controlling investors in the companies whose shares they acquired.[40]

Mutual investment companies computed their net or taxable income in the same manner as regular corporations, except that the dividends received deduction, which was lowered to 85% in the '36 Act, did not apply to investment companies.[41] That is, dividends received from other corporations were fully subject to corporate tax in the hands of mutual investment companies. Instead, mutual investment companies, but not regular corporations, were permitted to deduct dividends received in the previous taxable year against net income dividends paid during the current taxable year.[42]

The income, diversification, and distribution requirements of the '36 Act laid the foundation for the tax treatment of investment companies that in substantial measure continues today in Subchapter M. One consequence of the '36 Act changes was the conversion of income from portfolio investments into dividend income. That is, a distribution received from an investment company was taxed as an ordinary dividend and did not reflect the tax character of the underlying income of the investment company. For dividends and interest received by an investment company, a shareholder received, in essence, pass-through treatment. For tax-exempt interest and capital gains, however, a shareholder of an investment company was potentially worse off by earning such income through an investment company because the character of the income was transformed from tax-exempt interest or capital gains to ordinary dividend income.[43] Many of the subsequent changes in the taxation of investment companies were aimed at ameliorating this tax detriment by refining the pass-through treatment of investment company income.

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a portfolio's expected return. Diversification has long been recommended as a way to reduce investment risk. For example, see Solomon's admonition in Ecclesiastes: "Cast your bread upon the waters, for after many days you will find it again. Give portions to seven, yes to eight, for you do not know what disaster may come upon the land." *Ecclesiastes* 11:1–2.

40. *See* Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1475 (1991) (discussing purpose of diversification requirement).

41. Revenue Act of 1936 § 13(a)(2) (no dividends received deduction ("DRD") for mutual investment companies); *id.* § 26(b) (85% DRD for dividends from domestic corporations); *id.* § 27 (dividends paid credit equal to amount of dividends paid during the taxable year).

42. *Id.* § 13(a)(3). The deduction for dividends paid during the year applied for purposes of both the regular corporate income tax and the surtax on undistributed profits. *Id.* § 14(a)(2) (calculating tax based on surtax, undistributed net income, by subtracting from net income the credit for dividends paid under section 27).

43. *See id.* § 22(b)(4) (excluding interest on state and municipal bonds from gross income); *id.* § 117(a) (providing for an exemption for a certain percentage of capital gains ranging from 0% to 70% depending on the taxpayer's holding period).

One puzzle is why investment entities were not organized as general or limited partnerships. If an investment company were organized as a partnership, the individual partners would be taxed on their share of the investment partnership's income without any entity-level taxation, and the income would retain the same tax character in the hands of the partners as it had in the hands of the partnership.[44] A general partnership would probably not be a suitable investment vehicle because of the potential for unlimited liability of the individual partners for the debts and obligations of the partnership (and possibly the ability of the individual partners to bind the partnership and participate in partnership governance). A limited partnership, however, would eliminate the risk of unlimited liability for the limited partners (but not for the general partner) and prevent unwanted interference in partnership governance. At that time, however, limited partnerships were not widely employed, perhaps because of concerns over the potential scope of partner liability and other uncertainties regarding limited partner rights.[45]

Because closed-end funds did not offer shareholders the right to redeem their shares, closed-end funds were subject to entity-level taxation but open-end funds were not. This gave open-end funds a potential competitive advantage.[46] A desire to eliminate this tax disadvantage has been proffered as one of the main reasons closed-end funds joined with open-end funds to support the legislation that would become the Investment Company Act of 1940.[47]

B. The Investment Company Act of 1940

Congress enacted the Investment Company Act of 1940 ("the '40 Act") to address perceived abuses by investment companies, including inadequate disclosure, abusive transactions with related parties, opaque capital structures, shoddy accounting, and excessive leverage.[48] The

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44. Representatives of certain investment companies urged Congress to apply the partnership theory of taxation to investment companies in the '36 Act in order to treat investors equitably. *Revenue Act, 1936: Hearing on H.R. 12395 Before the S. Comm. on Fin.*, 74th Cong. 799–801 (1936) (letter from Paul C. Cabot, President, State Street Investment Corporation and Merrill Griswold, Chairman of the Board, Massachusetts Investors Trust, to Sen. Walsh).

45. *See* Comment, *The Limited Partnership*, 45 YALE L.J. 895, 902–04 (1936) (discussing limited partnerships under the Uniform Act and noting that limited partnerships offered few other advantages to investor looking for limited liability and a share of profits).

46. The extent of this advantage would depend on several factors, including the difference between the corporate tax rate and individual tax rate, the amount of the DRD, the composition of a fund's income (including dividend, capital gains, and tax-exempt interest income), and the treatment of losses.

47. FINK, *supra* note 18, at 35.

48. 15 U.S.C. §§ 80a-1(b)(1)–(8) (2012) (stating findings and declaration of policy of the '40 Act). The findings that led to the '40 Act are found in SEC. & EXCH. COMM'N, REPORT ON

'40 Act regulates, inter alia, the disclosure of a fund's investment policies and objectives, the content of the investment advisory contract, dealings between a fund and its advisor, a fund's capital and corporate structures, and restrictions on investments. Enacted pursuant to the same findings that engendered the '40 Act, the Investment Advisers Act of 1940,[49] regulates investment advisers, such as fund managers.[50]

The '40 Act regulates "investment companies,"[51] the most important being "management companies."[52] An investment company can be either an "open-end company" or "closed-end company."[53] Management companies are further classified as either "diversified" or "non-diversified."[54] These requirements were similar to the diversification requirements that a company had to satisfy in order to qualify as a mutual investment company for tax purposes.[55]

The enactment of the '40 Act brought both closed-end and open-end funds under the same regulatory regime, although special rules applied to each type of fund.[56] Because closed-end funds supported the '40 Act, the Securities and Exchange Commission ("SEC") in turn advocated extending to closed-end funds the same tax benefits

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INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 75-707 (1939). This report was commissioned by Congress in section 30 of the Public Utility Holding Company Act of 1935.

49. 15 U.S.C. §§ 80b-1–21.

50. The leading treatise on the Investment Advisers Act of 1940 is HARVEY E. BINES & STEVE THEL, INVESTMENT MANAGEMENT LAW AND REGULATION (2d ed. 2004).

51. 15 U.S.C. § 80a-3 (defining investment company).

52. *Id.* § 80a-4 (classifying investment companies as either "face-amount certificate company," "unit investment trust," or "management company").

53. *Id.* §§ 80a-5(a)(1)–(2).

54. *Id.* §§ 80a-5(b)(1)–(2). To qualify as diversified, a management company must ensure that at least 75% of its total assets are limited to any single issuer to an amount not greater than 5% of the value of the total assets of the management company and not more than 10% of the outstanding voting stock of the issuer. *Id.* § 80a-5(b)(1). A company that is diversified can only become non-diversified if a majority of its shareholders assent. *Id.* § 80a-13(a)(1).

55. *See* Revenue Act of 1938, ch. 289, §§ 361(b)(1)–(2), 52 Sta. 447, 553. The '40 Act also imposed limits on the amount of leverage a fund can employ. Open-end companies may not issue debt securities, but they can borrow directly from a bank to finance a portion of their portfolio purchases. 15 U.S.C. § 80a-18(f)(1) (requiring asset coverage of at least 300%). Closed-end funds may issue debt securities and preferred stock under limited circumstances, in addition to borrowing from banks to fund portfolio purchases. *Id.* § 80a-18(a)(1) (asserting that immediately after issuance of debt, a fund must have asset coverage of at least 300%); *id.* § 80a-18(a)(2) (asserting that immediately after issuance of preferred stock, a fund must have asset coverage of at least 200%). One potential effect of limiting leverage, besides limiting the volatility and riskiness of the fund, is to limit interest deductions and thereby increase the investment company's (and shareholders') income.

56. For example, closed-end and open-end funds are subject to different rules regarding the pricing and distribution of shares. *See, e.g.*, *id.* § 80a-22 (regulating distribution and pricing of shares of open-end funds).

previously accorded only to open-end funds.[57] This occurred with the enactment of the Revenue Act of 1942.

C. The Revenue Act of 1942

The Revenue Act of 1942 ("the '42 Act") established the modern statutory tax regime applicable to regulated investment companies.[58] It also firmly established the link between the special mutual fund income tax regime and the new SEC rules. To qualify as a RIC, an entity must be a U.S. corporation (including a trust taxed as a corporation) and must be registered under the '40 Act as a management company or unit investment trust.[59]

The '42 Act also modified the prior income and diversification tests. In particular, to be a RIC, a corporation had to derive at least 90% (previously 95%) of its gross income from dividends, interest, and gains from the sale of stock or securities, and less than 30% of the gross income had to be earned from the sale of stock or securities held for three months or less.[60] Under the new, slightly relaxed diversification rules, at least 50% of a RIC's total assets at each quarter end had to consist of cash, government securities, securities of other RICs, and securities of other companies, but in making this determination, the securities of a single issuer were limited to 5% of the RIC's total assets and not more than 10% of the outstanding voting securities of the issuer.[61] In addition, not more than 25% of a RIC's total assets could be invested in a single issuer or two or more issuers that the RIC controlled and determined to be engaged in the same or similar trades or businesses.[62] It should be noted that failing to satisfy the diversification tests of the '40 Act merely meant that a fund could not advertise itself as being "diversified," but failing to satisfy the RIC diversification

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57. FINK, *supra* note 18, at 34–37.

58. Revenue Act of 1942, ch. 619, § 170, 56 Stat. 798, 87–81 (originally codified at I.R.C. §§ 361, 362 (1939) as amended in 1942).

59. I.R.C. § 361(a) (1939) (as amended in 1942). Common trust funds exempt from regulation under section 3(c)(3) of the '40 Act are also eligible to be taxed as a RIC. A common trust fund for these purposes is a fund maintained by a bank to collect and invest capital received in its capacity as a trustee, etc., in connection with fiduciary accounts such as trusts and estates.

60. *Id.* §§ 361(b)(1)–(2). The short-term trading limit was unchanged.

61. Value is market value if available or fair value determined by the board of directors. *Id.* § 361(b)(3).

62. *Id.* The statute defines control to be ownership of 20% or more of the total combined voting power of all classes of voting stock. *Id.* The '42 Act also enacted provisions to prevent a RIC from failing the diversification tests in a subsequent quarter solely because of appreciation or depreciation in the securities in its portfolio, including the possibility of adjusting its portfolio within thirty days of the quarter close. *Id.*

requirements in the '42 Act caused a fund to be subject to corporate tax on all its income (not reduced by dividends paid).

The '42 Act did not alter the requirement that a RIC distribute at least 90% of its net income for the year to avoid corporate tax. If the distribution requirement was met, a RIC was subject to the regular corporate tax on its *adjusted net income*, but adjusted net income was regular income *reduced* by dividends paid.[63] In addition, the '42 Act provided for the separate treatment of net capital gains ("NCGs") for both RICs and RIC shareholders. A RIC avoided tax on its NCGs by distributing them,[64] and capital gain dividends received by a RIC shareholder were treated as long-term capital gains, regardless of the length of the shareholder's holding period.[65] A RIC thus avoided entity-level tax by distributing its adjusted net income and NCGs.[66] The separate treatment of NCGs was the initial step in moving the RIC regime towards a pass-through regime in which the character of RIC income carried over to its shareholders when distributed.

The distribution requirement was not as burdensome for open-end funds as for closed-end funds because open-end funds could replenish capital continuously. A closed-end fund, on the other hand, could not replenish capital as easily because raising capital required a costly share offering, and distributions thus inexorably lowered assets. This, and the lack of a redemption privilege, may be why closed-end funds, although they have not disappeared, have been greatly eclipsed by open-end funds and more recently by exchange traded funds ("ETFs").[67]

D. Summary

The '42 Act established the RIC tax regime that continues largely unchanged seventy years later. To avoid corporate tax, a RIC must adhere to the provisions of the '40 Act, comply with certain

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63. *Id.* § 362(b)(1) (stating that tax base is adjusted net income excluding net capital gain minus the basic surtax credit of section 27(b), which is the sum of the dividends paid plus consent dividends). Corporations were subject at this time to both a regular income tax and a surtax. A RIC's surtax base was its net income, excluding net capital gain, less dividends paid (other than capital gain dividends), plus consent dividends credit. *Id.* § 362(b)(2).

64. A RIC was subject to tax on the excess of net long-term capital gains over the sum of: (1) net short-term capital loss; and (2) capital gain dividends, which were dividends designated by a RIC as capital gain dividends. *Id.* §§ 362(b)(5), (7).

65. *Id.* § 362(b)(6).

66. RICs were subject to special tax rates on undistributed income: 24% on surtax net income, 16% on net income, and 25% on net capital gains. *Id.* §§ 362(b)(3)–(5).

67. Open-end RICs constitute 90% and closed-end funds constitute 1.8% of investment company total net assets. INV. CO. INST., *supra* note 1, at 9 fig.1.1. It was difficult for closed-end funds to offer redemption privileges because of the changes in the '40 Act that restricted redemptions by funds when the fund shares traded at a discount.

diversification requirements, and distribute most of its earnings. The RIC tax regime thus imposes certain structural costs on RICs and their shareholders, such as the distribution requirement and the need to determine and track the tax character of a RIC's income. These distribution costs, however, are a function of a RIC's taxable income, which the fund manager controls to some extent.

II. SUBCHAPTER M

This Part briefly reviews the current RIC tax regime.[68] It does not delve into the intricacies of Subchapter M, but aims to highlight material changes since 1942 and focus on certain structural features that may generate tax externalities for tax-exempt and taxable shareholders.[69]

A. RIC Qualification

As under the Revenue Act of 1942, to qualify as a RIC, an entity must be a U.S. corporation that is a registered management company under the '40 Act and must make an annual election to be a RIC.[70] A RIC still must satisfy the 90% gross income test, but the types of income that count towards this test have been expanded to include not only dividends,[71] interest (both taxable and tax-exempt), and gains from the sale of stock and securities,[72] but also gains realized from foreign currencies, and derivatives based on stock or securities such as options, forwards, and futures.[73] Income related to a RIC's investment activities

68. The provisions of the Internal Revenue Code that address the taxation of mutual funds are found primarily in Subchapter M, Part I of the Code, sections 851 through 855.

69. The leading modern tax treatise on RICs is SUSAN A. JOHNSTON & JAMES R. BROWN, JR., TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS (2012).

70. I.R.C. § 851(a)(1)(A) (2012). Unit investment trusts, business development companies, and certain common trust funds are also eligible to be RICs. *See id.* §§ 851(a)(1)(B), (a)(2).

71. Qualifying income also includes Subpart F inclusions under section 951(a)(1)(A)(i) and certain PFIC inclusions. *Id.* § 851(b); Treas. Reg. § 1.851-2(b)(2) (2013).

72. The definition of security for purposes of section 851(b)(2) is the same as security under section 2(a)(36) of the '40 Act. 15 U.S.C. § 80a-1 (2012); I.R.C. § 851(b).

73. I.R.C. § 851(b)(2)(A). The *net* income from an interest in a qualified publicly traded partnership is also included. *Id.* § 851(b)(2)(B). This 2004 provision permits a RIC to include only the net income from a qualified publicly traded partnership for purposes of the income tax instead of having to include its proportionate share of the partnership's tax items, which would occur in the case of an investment in a non-qualified partnership. *See id.* § 851(b) (providing that income derived from a partnership or trust shall be treated as satisfying the 90% requirement only to the extent that such income is attributable to items of income of the partnership or trust). The IRS has clarified in rulings that certain investments are "stock or securities" for purposes of section 851(b)(2). *See, e.g.*, Rev. Rul. 74-177, 1974-1 C.B. 165 (clarifying that interests in REITs are stock or securities); I.R.S. Priv. Ltr. Rul. 200846019 (Nov. 14, 2008) (holding that income from participating loan was qualifying income); I.R.S. Priv. Ltr. Rul. 200602032 (Jan. 13, 2006)

is also included as gross income under the test.[74] The 30% limit on short-term trading gains was eliminated in 1997.[75]

Before 2010, if an entity failed the 90% test, it would not qualify as a RIC and would be subject to corporate tax. Under new section 851(i), an entity otherwise failing the 90% test will be treated as having satisfied the 90% test if the entity discloses each item of its gross income and the failure was due to reasonable cause not willful neglect.[76] The RIC is also subject to tax on a portion of the non-qualifying income.[77]

(holding that income and gain from forwards, futures, and options on foreign currencies are qualifying income); I.R.S. Priv. Ltr. Rul. 9012008 (Dec. 15, 1989) (holding that option on futures contract on U.S. government securities is "security"). Since investments in commodities, such as grains, gold, and silver, are not securities under the '40 Act, income and gain from such investments, including derivatives related to such commodities, do not constitute qualifying income. Rev. Rul. 2006-1, 2006-1 C.B. 939 (holding that income from long notional principal contract in which RIC paid three-month Treasury bill rate plus any depreciation in commodity index and received any appreciation in commodity index was not qualifying income; contract not security and not entered into in connection with business of investing in stock, securities, or currencies), *modified*, Rev. Rul. 2006-31, 2006-1 C.B. 1133 (clarifying that Rev. Rul. 2006-1 was not intended to preclude conclusion that income from structured notes creating commodity exposure is qualifying income). Income and gain from the sale of direct interests in real estate are not qualifying income, although direct ownership of real estate is not prohibited. Rev. Rul. 85-167, 1985-2 C.B. 178. Interests in a REIT, however, constitute securities under section 851(b)(2). Rev. Rul. 74-177, 1974-1 C.B. 165 (holding that interests in REITs are stock or securities), *modified*, Rev. Rul. 89-81, 1989-1 C.B. 226 (holding that to the extent that 74-177 approves non-proportionate designations of particular types of income, it is not a proper interpretation of law). The 90% gross income limit is not strictly binding as it can be easily avoided through the use of a so-called "blocker" foreign corporation. A RIC that may run afoul of the 90% gross income limit because of commodity related income could form a wholly owned foreign corporation and have the foreign corporation make the commodity investments. To the extent that such income is treated as Subpart F income, it would be qualifying income for purposes of the 90% test. Under section 851(b)(2), Subpart F inclusions from a controlled foreign corporation ("CFC") are treated as dividends (good income), even if the underlying income by the CFC would not otherwise be qualifying income. I.R.C. § 851(b)(2). The IRS has issued numerous private letter ruling blessing these structures. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 201129002 (Apr. 8, 2011) (defining CFC's Subpart F income as qualifying income under section 815(b)(2)). *See generally* Willard B. Taylor, *"Blockers," "Stoppers," and the Entity Classification Rules*, 64 TAX LAW. 1 (2010). The investment in a CFC would be subject to the 25% diversification tests.

74. I.R.C. § 851(b)(2)(A). This provision ensures that items such as litigation recoveries, income tax refunds, and payments from investment advisors constitute qualifying income. *See, e.g.*, Rev. Rul. 92-56, 1992-2 C.B. 153 (holding that reimbursement from investment advisor is qualifying income).

75. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 787 (codified as amended at I.R.C. § 851).

76. I.R.C. § 851(i)(1). This provision, enacted as part of the Regulated Investment Company Modernization Act of 2010, Pub. L. 111-325, is effective for post December 22, 2010 tax years. The government has not issued any guidance on the scope of the reasonable cause exception under section 851. Some practitioners look to how it has been interpreted under the REIT rules. *See* Treas. Reg. § 1.856-7(c)(1) (explaining that failure to meet an income source requirement

In addition to the gross income test, a RIC must also satisfy, at quarter end, two diversification tests: the 50% and 25% tests.[78] These tests are identical to the diversification tests of the Revenue Act of 1942, except that not more than 25% of a RIC's total assets can be invested in the securities of one or more publicly traded partnerships.[79]

For both diversification tests, value is the market value if a market quotation is available.[80] As under the Revenue Act of 1942, RICs continue to be protected against failing the diversification test due to subsequent changes in value of their investments.[81]

B. The Taxation of RICs

The current RIC tax regime largely follows the regime enacted in 1935 and modified in 1942. The most significant changes relate to the expansion of the categories of RIC income that retain their tax character in the hands of RIC shareholders.

To qualify as a RIC, an entity is required to distribute at least 90% of the sum of: (1) investment company taxable income ("ICTI") (determined without regard to the dividends paid deduction);[82] and (2) tax-exempt interest (less disallowed deductions attributable to the tax-exempt interest).[83] If the 90% test is satisfied, a RIC may deduct

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will be considered reasonable cause, not willful neglect, if REIT exercised ordinary business care and prudence); Lee A. Sheppard, *Continuing Problems for Mutual Funds Despite RIC Mod*, 138 TAX NOTES 1029, 1030 (2013) ("RIC Mod[ernization Act] significantly reduced the chances of a RIC losing RIC status by instituting intermediate sanctions for unintentional failure of the asset test . . . or gross income test . . . .").

77. The tax applies to the excess of income from non-qualifying sources over one-ninth of the gross income of the RIC that is from qualifying sources. I.R.C. § 851(i)(2). Any tax paid is deductible in computing a RIC's ICTI. *Id.* § 852(b)(2)(G).

78. *Id.* § 851(b)(3).

79. *Id.* § 851(b)(3)(B)(iii).

80. *Id.* § 851(c)(4). If there is no market quotation available, value is "fair value," as determined by the RIC's board of directors. *Id.*

81. *Id.* § 851(d)(1) (stating that a RIC will not fail a diversification test solely as a result of changes in the market value of a portfolio from one quarter to the next, unless the diversification test is not satisfied immediately after the acquisition of any security and is partly or wholly the result of such acquisition). Furthermore, a RIC has up to thirty days to cure any failure to satisfy the diversification requirement resulting from intra-quarter acquisitions. *Id.* The regulations clarify that distributions will not cause a RIC to otherwise fail to satisfy the diversification test. *Id.* § 851(d); *see* Treas. Reg. § 1.851-5 ex.5. A RIC that otherwise fails the diversification test will be treated as satisfying it if the failure was due to reasonable cause or was considered to be de minimis and corrected with six months. I.R.C. §§ 851(d)(2)(A)–(B). If the failure is not de minimis, a RIC may be subject to an excise tax. *Id.* § 851(d)(2)(C).

82. ICTI is corporate taxable income but excluding any NCG and without allowance for any net operating loss ("NOL") carryover or carryback and the deduction for dividends received. *Id.* §§ 852(b)(1), (b)(2)(A)–(C).

83. *Id.* § 852(a)(1).

dividends paid to shareholders against its ICTI, thereby avoiding corporate tax on ICTI.[84]

Net short-term capital gains are included in ICTI, but their character as net short-term capital gains does not pass through to shareholders when distributed. This is disadvantageous to an individual RIC shareholder that has capital losses it cannot use otherwise, because the RIC dividend cannot be offset by the capital losses.[85]

Although net short-term capital gains (less any net long-term losses) are included in ICTI, NCGs are carved out of ICTI, and a RIC is taxed on the excess of its NCGs over the deduction for capital gain dividends paid.[86] Thus, a RIC that pays out all of its ICTI and NCGs avoids entity-level taxation.[87]

Tax-exempt interest does not constitute ICTI (though it is qualifying income), but such interest is included in the amount that must be distributed for an entity to qualify as a RIC.[88] When tax-exempt interest is distributed by a RIC, it retains its tax character, provided that the RIC is eligible to pay exempt-interest dividends.[89] A RIC is eligible to pay a

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84. *Id.* § 852(b)(2)(D). The deduction for dividends paid is determined under section 561(a). In general, only distributions from current or accumulated earnings and profits ("E&Ps") constitute "dividends" for this purpose. *Id.* §§ 561(a)(1), 562(a). Dividends declared in the last three months of the year are treated as paid on December 31, provided the dividends are paid in January of the following year. *Id.* § 852(b)(7). Pursuant to section 855, certain dividends declared after October 15 of the close of the taxable year and paid within the twelve-month period following the close of the taxable year (so called "spillback" dividends) are treated for purposes of the distribution requirement, ICTI, and NCG, as having been paid in the prior year. *Id.* § 855(a). Finally, a RIC can avoid corporate tax by paying a deficiency dividend. *See id.* § 860 ("If a determination with respect to any qualified investment entity results in any adjustment for any taxable year, a deduction shall be allowed to such entity for the amount of deficiency dividends for purposes of determining the deduction for dividends paid . . . for such year."). An exhaustive treatment of the intricacies of the dividend deduction is found in JOHNSTON & BROWN, *supra* note 69, ¶¶ 3.03–3.06.

85. To the extent that a RIC dividend consists of "qualified dividends" it has received, the dividend will be a "qualified dividend" under section 1(h)(11) and thus taxed at a maximum rate of 20% in the hands of an individual shareholder. I.R.C. § 854(b)(1)(B).

86. *Id.* § 852(b)(3)(A). In calculating NCG, a RIC can elect to push to the following year any net capital loss or net long-term capital loss realized after October 31 of the taxable year. *Id.* § 852(b)(8).

87. Capital gain dividends can be paid during the taxable year, but can also be paid in the succeeding year as a "spillback" dividend pursuant to an election under section 855. Also, in the case of an adjustment to a RIC's taxable income in a subsequent year arising from a court decision, an agreement with the IRS arising from an audit, or a statement on an amended return, the RIC can eliminate any tax deficiency by paying a deficiency dividend. *See id.* § 860 (defining a deficiency dividend as a distribution of property made by the qualified investment entity). If the gains are small or a fund wishes to retain assets, the distribution costs may exceed the corporate tax with respect to the NCGs, and it may therefore not be efficient to distribute the NCGs.

88. *Id.* §§ 851(b), 852(a)(1)(B).

89. *Id.* § 852(b)(5)(B). Under a 2010 amendment to section 852(c)(1)(B)(i), the E&Ps of a RIC, which generally are not reduced by any amount not allowable as a deduction, may be

tax-exempt dividend if at the close of each quarter at least 50% of the RIC's assets are tax-exempt obligations.[90] As a result of this rule, tax-exempt interest will generally be paid only by funds that exclusively hold tax-exempt bonds.

ICTI is generally computed under normal corporate tax rules with certain adjustments,[91] including special rules for capital losses:[92] the excess of net short-term capital losses ("STCLs") over net long-term capital gains ("LTCGs") is treated as a STCL in the succeeding year, and the excess of any net long-term capital losses ("LTCLs") over net short-term capital gains ("STCGs") is treated as a LTCL in the succeeding year.[93] There is no limit on the number of taxable years a net capital loss ("NCL") can be carried forward.[94]

In addition to the Subchapter M distribution requirements, section 4982 imposes a nondeductible 4% excise tax on a RIC unless it distributes each calendar year 98% of the RIC's *ordinary income*;[95] plus 98.2% of the RIC's *capital gain net income*[96] for the one-year period ending on October 31.[97] The purpose of section 4982 is to penalize

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reduced by amounts not deductible under sections 265 (disallowance of interest incurred to carry tax-exempt bonds) and 171(a)(2) (amortizable bond premium relating to tax-exempt interest). This change prevents RICs that hold tax-exempt bonds from having E&Ps solely as a result of these disallowed expenses.

90. *Id.* § 852(b)(5). Tax-exempt interest of a RIC that is not eligible to pay a tax-exempt dividend will generate E&Ps in the hands of the RIC and distribution of such amounts will constitute a taxable dividend to RIC shareholders.

91. *Id.* §§ 852(b)(2)(A)–(G).

92. Generally, a corporation can only use a capital loss to the extent of its capital gains. Any excess capital loss is generally treated as a capital loss carryback to the three preceding taxable years and then to the five succeeding years. *Id.* §§ 1212(a)(1)(A)–(B). A capital loss cannot be carried back to a year if the carryback would increase or produce a net operating loss. *Id.* § 1212(a)(1)(A)(ii). Any carryforward or carryback is treated as a short-term capital loss. *Id.* § 1212(a)(1).

93. *Id.* § 1212(a)(3). This rule, which follows the treatment of capital losses for individuals, was revised in 2010. Prior to the 2010 revisions, a RIC could carryforward a capital loss for only eight years, and it was treated as a STCL. I.R.C. § 1212(a)(1)(C) (2006). Treating capital loss carryforwards as short-term capital losses is generally favorable to RIC taxable shareholders: since short-term losses first offset short-term gains, a RIC would have potentially more long-term capital gains to pass through to shareholders.

94. In addition, prohibiting a RIC from carrying back a capital loss obviates the need for RIC shareholders to file amended returns.

95. Ordinary income for purposes of section 4982 is calendar year ICTI, computed without regard to any capital gains or losses and the dividends paid deduction. I.R.C. § 4982(e)(1) (2012).

96. Capital gain net income is the excess of capital gains over capital losses, reduced (but not below net capital gain) by a RIC net ordinary loss for the calendar year. *Id.* §§ 4982(e)(2)(A)–(B).

97. *Id.* §§ 4982(a)–(b)(1). This amount is increased by prior year shortfalls and decreased for prior year over-distributions. *Id.* §§ 4982(b)(2)–(c)(2). If a RIC has a taxable year that ends on

RICs that defer distributing taxable income.[98] If a RIC invests in other entities, however, such as another RIC, a REIT, or partnership, it may be difficult to avoid the excise tax because the RIC may not receive in time the requisite tax information to calculate the required distribution. The section 4982 excise tax does not apply to a RIC, however, if at all times during the calendar year each shareholder was a trust described in section 401(a), which is exempt from tax under section 501(a).[99]

Unlike partnerships and S corporations, RICs cannot pass through expenses in excess of ICTI or net capital losses. Instead, these tax attributes remain at the corporate level. The presence of these corporate-level attributes potentially affects tax-exempt shareholders because fund managers may view these attributes as wasting assets—to the extent that they are not used, their present value declines. Consequently, a fund manager may have the incentive to accelerate income or gain, for example, by selling assets with built-in gains, to extinguish these tax attributes as soon as possible. Sales that are undertaken solely to reduce net operating losses ("NOLs") or capital loss carryovers generate costs that are borne by tax-exempt shareholders, but provide no direct benefit.[100]

C. The Taxation of RIC Shareholders

A distribution received by a taxable RIC shareholder constitutes a dividend to the extent that it is attributable to either a RIC's current or accumulated E&Ps.[101] A dividend will be a *qualified dividend* subject

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November 30 or December 31, it can elect to calculate its capital gain net income by using its taxable year. *Id.* § 4982(e)(4). The excise tax and Subchapter M distribution regimes are somewhat distinct in their time coverage. Under section 852, a RIC must comply with the distribution requirements for its taxable year, whereas section 4982 generally requires distributions to be made based on the calendar year. *Id.* §§ 852, 4982. The calculations (and required distributions) will thereby be different.

98. *See* JOHNSTON & BROWN, *supra* note 69, ¶ 4.03.

99. I.R.C. § 4982(f). Section 4982(f) was added in 1988. An Act to Make Technical Corrections to the Tax Reform Act of 1986, Pub. L. No. 100-647, § 1006(I)(6), 102 Stat. 3342 (1988). Section 4982(f) was amended in 2010, to extend the exemption beyond insurance company accounts and section 401(a) trusts. Regulated Investment Company Modernization Act of 2010, Pub. L. No. 111-325, § 401(a), 124 Stat. 3537. The legislative history to the 2010 amendments describes the reason for the changes: "RICs, in which all shareholders are section 401(a) trusts or segregated accounts underlying insurance contracts, are not subject to the annual RIC excise tax because these shareholders would not benefit from deferring tax through a RIC." Regulated Investment Company Modernization Act of 2010, H.R. 4337, 111th Cong. (2010). At least one fund has taken advantage of this tax provision. Transamerica Index Funds, Inc., Annual Report (Form N-CSR) (Mar. 4, 2004) (making no provision for excise taxes, regardless of the amount of distributions).

100. *See infra* Part IV.B (explaining how fund managers change their investment strategy based on the tax-exempt status of shareholders).

101. I.R.C. § 311.

to a maximum tax rate of 20%[102] to the extent that a RIC designates the dividend as being a *qualified dividend*.[103]

An individual RIC shareholder who receives a capital gain dividend can treat the capital gain dividend as a long-term capital gain, which is currently taxed at a maximum rate of 20%.[104] Likewise, exempt interest dividends are treated as tax-exempt interest under section 103.

Although losses and expenses of a RIC are not passed through to its shareholders, if more than 50% of the total value of a RIC's assets at year-end is made up of foreign stock or securities, the RIC can make an election under section 853 to enable its shareholders to credit foreign taxes paid by the RIC under section 901.[105] If a RIC makes the section 853 election, it grosses up the dividends paid deduction by the amount of foreign taxes, and the RIC shareholders must include the amount of foreign taxes paid by the RIC in their income.[106]

For corporate shareholders, a RIC can designate an amount of its dividends received as being eligible for the dividends received deduction.[107] The corporate shareholder is also subject to the same

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102. *See id.* § 1(h)(11)(B) (defining qualified dividend income).

103. *Id.* § 854(b)(1)(B). If the qualified dividend income of a RIC is 95% or more of a RIC's gross income (as specially defined), then the entire amount of the dividend will be a qualified dividend. *Id.* § 854(b)(1)(B)(iii). A RIC may designate an amount as a qualified dividend generally to the extent that a RIC has received qualified dividend income. *Id.* § 854(b)(1)(C)(ii). Notice 2004-39 sets forth special rules for applying the differing tax rates in section 1(h) to the capital gains dividends paid by RICs and REITs. I.R.S. Notice 2004–39, 2004–22 I.R.B. 982. The amount designated as a qualified dividend may also not exceed the aggregate dividends received by a RIC. I.R.C. § 854(b)(1)(C)(i).

104. *Id.* § 852(b)(3)(B). A capital gain dividend is a dividend reported by the company in a written statement, such as a Form 1099, to its shareholders. *Id.* § 852(b)(3)(C)(i). A RIC shareholder must also include in income any undistributed capital gains (limited to the amount the shareholder would have received if all capital gains subject to tax had been distributed to the RIC's shareholders at the close of its taxable year). *Id.* § 852(b)(3)(D)(i). In such case, the shareholder is deemed to have paid the corporate tax paid by the RIC and can receive a credit for such taxes. If a RIC has multiple classes of stock, any capital gains, tax-exempt interest, or foreign tax credit designation must be made in proportion to the dividends paid on each class. Rev. Rul. 89-81, 1989-1 C.B. 226.

105. I.R.C. § 853(a)(1). The RIC must also satisfy the distribution requirements of section 852(a). *See id.* § 853(a)(2). A RIC can also pass through to its shareholders credits from certain bonds, such as qualified tax credit bonds and Build America bonds. *See id.* § 853A.

106. *Id.* § 853(b)(1). The RIC shareholders also are permitted to treat as foreign source income the proportionate share of taxes and proportionate share of dividends paid by the RIC. *Id.* § 853(b)(2). For a RIC that pays foreign taxes, but does not make the 853 election, it may either credit the foreign taxes against its ICTI under section 901 and 904 or deduct the foreign taxes under section 164. The regulations clarify that taxes deemed paid under section 902 are not eligible for the section 853 election.

107. *Id.* §§ 854(b)(1)(C)(i), (b)(2)(A), (b)(3). The aggregate dividends include only dividends received from U.S. corporations that would be eligible for the dividends received deduction after application of sections 246 (minimum holding periods) and 246A (limitation on debt-financed dividends). *Id.* § 854(b)(2). For these purposes, dividends do not include distributions from

requirements under sections 243 and 246A as the RIC, and dividends received from a RIC are subject to the 70% dividends received deduction regardless of the corporate shareholder's ownership of the RIC or the RIC's ownership of the underlying dividend paying stock.[108]

RIC distributions are generally taxable in the year in which they are received, but in some circumstances, distributions in a subsequent year are treated as if they were paid in the prior year, for purposes of both shareholder taxation and calculation of a RIC's ICTI (and excise tax).[109] These provisions allow a RIC extra time in which to compute ICTI and ensure the distribution requirements have been satisfied.

When a RIC realizes a taxable income or gain, it is taxed to the shareholders who actually receive (or are treated as having received)[110] the distribution of ICTI or NCGs.[111] The income or gain, however, could have economically accrued long before the shareholders who receive distributions became shareholders. A RIC shareholder could have paid for the accrued gain when he purchased shares of the RIC,

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certain tax-exempt entities or REITs. *Id.* § 854(b)(3)(B).

108. *Id.* § 854(b)(1)(A).

109. Under section 852(b)(7), if a dividend declared in October, November, or December of any calendar year, is payable to shareholders of record on a specified date in one of the months, and received in January of the following year, the dividend is deemed to have been received on December 31 of the prior year. *Id.* § 852(b)(7). Under section 855, if a RIC declares a dividend prior to its return filing date (including extensions) and distributes the dividend within twelve months following the close of the taxable year, but no later than the date of the first dividend payment or the same kind of dividend distribution, the RIC can elect on its return to treat the dividend as having been paid during the prior taxable year. *Id.* § 855(a). The dividend is still treated for tax purposes as having been received by the shareholder in the year of distribution. *Id.* § 855(b); Treas. Reg. § 1.855-1(c) (2013). This provision permits a RIC to ensure that it has complied with the distribution requirement and also is effective for purposes of computing ICTI, capital gains dividends, and tax-exempt interest dividends, but is not effective in reducing the section 4982 excise tax. The one-year deferral permitted by section 855 has been curtailed by the enactment of the section 4982 excise tax. I.R.C. § 4982(c)(3). Under section 860, in the case of an adjustment to a RIC's taxable income in a subsequent year arising from a court decision, agreement with the IRS arising from an audit, or a statement on an amended return, the RIC can eliminate any tax deficiency by paying a deficiency dividend. *Id.* § 860(a). For a detailed discussion of these provisions, see JOHNSTON & BROWN, *supra* note 69, ¶¶ 3.03–3.06, 4.03.

110. Under section 852, a RIC shareholder will be treated as having received undistributed capital gains dividends (and paid tax on such gains) designated by the RIC in a notice to the shareholder within sixty days of the close of its tax year. I.R.C. § 852(b)(3)(D)(i).

111. In contrast, under Subchapter K, the allocation of built-in gains or losses to new partners is curtailed by section 704(c). *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4) (requiring the allocation of any built-in gain or loss under the principles of section 704(c) in the case of a revaluation of the partner's capital accounts upon a capital contribution by a new or existing partner). In the case of a sale of a partnership interest, if the partnership has a section 754 election in effect, the basis of the partnership property is adjusted with respect to the purchasing partner under section 743. I.R.C. §§ 743, 754. In certain circumstances, these adjustments are mandatory. *See id.* §§ 704(c)(1)(C), 743(d)(1). These rules and their potential application to RICs are discussed *infra* Part V.B.

which would be reflected in the RIC's NAV, and when the gain is realized and distributed, he would be taxed on this gain again. When the gain is distributed, the RIC's NAV will decline, but this will provide no benefit to the shareholder until the shareholder sells the shares. Therefore, shareholders who receive distributions attributable to pre-acquisition gains in essence have their tax liabilities temporarily accelerated.

Because a new taxable shareholder can be taxed on a fund's gains that have accrued before the shareholder invested, taxable shareholders appear to be sensitive to the amount of a fund's tax overhang—the amount of a fund's total *unrealized* gains. There is evidence that fund managers manage a fund's overhang by strategically realizing gains and losses. Thus, even though tax-exempt shareholders do not pay tax on RIC distributions, they potentially bear their share of tax externalities caused by manager actions to manage overhang, ICTI, and NCG.[112] This has potentially detrimental consequences to shareholders, especially tax-exempt shareholders.[113]

Managers have some control over a RIC's ICTI and generally significant control over its NCG, and consequently, the tax liability of a RIC's taxable shareholders. When taxable shareholders predominate, managers appear to attempt to minimize overhang, ICTI, and NCG. When tax-exempt shareholders predominate, however, managers may actually become less concerned with minimizing overhang, ICTI, and NCG.[114]

D. Summary

A RIC generally avoids entity level-taxation by distributing its ICTI and NCGs, but its taxable shareholders are taxed on distributed income. Certain categories of income realized by a RIC retain their character when distributed, for example NCGs and tax-exempt interest—but a RIC, unlike a partnership and an S corporation, cannot pass through NOLs and net capital losses. These items remain corporate-level tax attributes and can be used to reduce future ICTI or NCG.[115] The RIC

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112. *See, e.g.*, Michael Barclay, Neil D. Pearson & Michael S. Weisbach, *Open-End Mutual Funds and Capital-Gains Taxes*, 49 J. FIN. ECON. 3, 30, 33 (1998) (finding evidence that managers reduce overhang to attract new investors).

113. *See infra* Part IV.C–D.

114. *See infra* Part IV.B (discussing the tax externalities suffered by taxable investors because of the presence of tax-exempt investors).

115. If a RIC were organized as a partnership or S corporation, the entity's expenses would generally constitute trade or business expenses (assuming the fund is a trader fund) and would be deductible without limit under section 162. Note, if the entity had issued debt, the interest expense of a limited partner that does not materially participate in the trader fund's activities

tax regime can be characterized as a partial or quasi pass-through regime, because not all of a RIC's income, gains, losses, or deductions pass through to its shareholders or retain their character when distributed.

As discussed below, the presence of these corporate-level tax attributes may cause fund managers to engage in trades that maximize the present value of these attributes, but that otherwise provide no value to tax-exempt shareholders. In addition, implementing the requirements of the RIC partial pass-through regime requires an expensive tax accounting operation to classify and track the underlying income and also to ensure compliance with the income and distribution requirements. It seems clear that none of these requirements benefit tax-exempt shareholders, but tax-exempt shareholders bear their share of these costs.

Gains of a RIC are allocated to the shareholders of record in the year the gains are realized and distributed, even though the gains may have accrued before the shareholders of record became shareholders. New shareholders may have to pay tax on these gains even though their shares have not increased in value (or may have even decreased in value) since they purchased them. Such shareholders will see their tax liability accelerated, at least until they sell their shares. Because new shareholders consider a fund's overhang when deciding whether to purchase shares, fund managers monitor their funds' overhang and appear to take actions to reduce it by, for example, realizing losses to offset gains. The costs of these actions are borne by all shareholders, but provide benefits only for taxable shareholders.

III. TAX-EXEMPT INVESTORS AND MUTUAL FUNDS

The contours of the current RIC tax regime were largely established in the Revenue Act of 1942.[116] From the 1940s through the early 1960s, mutual fund shareholders consisted almost exclusively of U.S. taxable individuals. With the creation of tax-exempt retirement plans for self-employed persons in 1962, however, mutual funds began for the first time to cater to and receive investments from self-directed, qualified retirement plans. A common characteristic of all qualified

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would be subject to the investment interest limitation of section 163(d), but the interest expense allowed under section 163(d) would be deductible in determining the partner's adjusted gross income. *See* Rev. Rul. 2008-38, 2008-2 C.B. 249 (addressing whether interest expenses attributable to indebtedness are attributable to property held for investment). Losses would retain their character and would be deductible by the owner, subject to the rules applicable to capital losses.

116. *See supra* Part I.C.

retirement plans (and other deferred compensation arrangements such as IRAs) is the exemption of income and gains realized from plan investments from current tax.[117] Thus, the tax character and timing of investment returns are irrelevant because the account or plan is generally tax-exempt.[118]

The tax-exempt investors began entering into mutual funds with the enactment of provisions authorizing the creation of retirement plans (known as "Keogh" or "H.R. 10 plans") for self-employed persons in 1962.[119] Keogh plans were permitted to invest in mutual funds because of a provision in the enabling legislation that specifically provided that bank custodial accounts invested solely in open-end mutual funds were one of the permissible funding recipients for Keogh plans.[120]

In establishing these new plans, Congress appears to have wanted to provide Keogh plan beneficiaries with the option of investing in the U.S. equity market in addition to the less risky choices of insurance company annuities, endowment, and life insurance contracts. Congress specifically did not offer Keogh plan beneficiaries the option of investing directly in individual shares or bonds of U.S. companies, but only in diversified, open-end RICs.[121] It appears that Congress believed that the statutory diversification requirements imposed on RICs under

117. *See* I.R.C. § 408(e); *id.* § 501(a). In certain circumstances, however, it is possible for a qualified retirement plan to be subject to unrelated business income tax ("UBIT"). *See id.* § 511. The UBIT provisions are beyond the scope of this Article.

118. With the exception of Roth IRAs and Roth 401(k) plans, distributions from qualified plans are taxed as ordinary income to the plan beneficiary when distributed. *See id.* §§ 72(a), 402(a)(1); *id.* §§ 403(a)(1), 408(d). Because contributions to Roth IRAs and Roth 401(k) plans are not deductible, qualified distributions from Roth IRAs are exempt from tax. *Id.* § 408A(c)(1); *id.* § 408A(d)(1). Earnings of Roth plans, however, are exempt from tax. *Id.* § 408A(a). For an overview of current retirement savings plans, see JOINT COMM. ON TAXATION, JCX-32-12, PRESENT LAW AND BACKGROUND RELATING TO THE TAX TREATMENT OF RETIREMENT SAVINGS (2012) (providing a summary of the applicable retirement savings arrangements and the various economic issues relating to retirement plans).

119. Self Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809 (codified in scattered sections of I.R.C.); *see* FINK, *supra* note 18, at 112–16. Before the enactment of Keogh plans, the only retirement plans available to individuals were defined benefit plans and a small universe of defined contribution plans administered by bank and insurance companies, neither of which generally invested in mutual funds. FINK, *supra* note 18, at 111.

120. I.R.C. § 401(f)(1) (1970) (treating certain custodial accounts invested solely in open-end RICs as qualified trusts). Other permissible funding methods for Keogh plans included annuities, endowment, or life insurance policies, and contributions to a trust with a bank (or similar institution) as trustee. The same provision also applied to custodial accounts of qualified retirement plans of corporations.

121. It is not clear why Congress determined that shares of closed-end RICs were impermissible investments. It may have been because of the discounts and premiums to NAV that occasionally arise with closed-end fund shares. The statute would be amended to permit investment in shares of closed-end RICs. Employee Retirement Income Security Act of 1974 § 401, 29 U.S.C. § 1022(d) (2012).

both the Internal Revenue Code and '40 Act provided a minimal level of protection for equity investments. Congress's focus on the diversification benefits of RICs would continue over the next couple of decades.

As contribution limits were raised over the next two decades,[122] the number of Keogh plans and Keogh plan assets increased significantly. By 1980, there were 225,000 plans with assets of $3.8 billion, and mutual funds held 40% of Keogh plan assets.[123]

Keogh plans were the first qualified retirement savings plans for self-employed persons, but over the next fifteen years Congress enacted a host of additional employee and non-employee retirement plans. IRAs were introduced in the Employee Retirement Income Security Act ("ERISA") in 1974.[124] IRAs were originally intended to provide a tax-favored retirement savings plan for employees who were not otherwise covered by a qualified retirement plan.[125] Importantly, the enabling legislation specifically provided that IRAs could be invested in the same assets that were acceptable for qualified plans, including stock of mutual funds, and that certain entities other than banks, including mutual funds, could serve as IRA custodians.[126] In the same legislation, Congress permitted custodial accounts invested in RIC stock to be treated as annuity contracts in retirement plans of nonprofits entities, so-called 403(b) plans.[127] Prior to this change, 403(b) plans could only invest in insurance company annuities.[128] The 403(b) RIC language tracked the RIC investment provisions for Keogh plans.

Since 1974, Congress expanded the IRA family to include Roth IRAs,[129] Coverdell Education Savings Accounts (formally "Education

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122. By 1982, Keogh plans were subject to the same limitations as corporate plans. FINK, *supra* note 18, at 114.

123. *Id.* at 115.

124. Employee Retirement Income Security Act § 2002(b).

125. H.R. REP. NO. 93-807 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4670, 4699.

126. *See* Treas. Reg. § 1.408-2(e) (2013) (describing rules for non-bank trustee).

127. I.R.C. § 403(b)(7) (2012) (amounts paid to a custodial accounts that invests in RIC stock is treated as a contribution for an annuity contract) (enacted in Employment Retirement Income Security Act § 1022(e)). The legislative history states the expansion of permissible funding vehicles for 403(b) plans was made to provide "more flexibility." H.R. REP. NO. 93-807 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4670, 4827. The statute was amended two years later to permit investment in closed-end funds. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1504(a), 90 Stat. 1520, 1738.

128. I.R.C. § 403(b)(1) (purchase of annuity contract by an employer described in section 501(c)(3) for employee is excluded from gross income of employee).

129. *Id.* § 408A (enacted in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 302, 111 Stat. 788). Roth IRAs were created in the Taxpayer Relief Act of 1997. *Id.* Unlike traditional IRAs, a contribution to a Roth IRA is not deductible, but both the earnings of *and* distributions from a Roth IRA are generally tax-exempt. *Id.* § 408A(a) (stating that Roth IRA treated in same

IRAs"),[130] Simple IRAs,[131] Simplified Employee Pension ("SEP") IRAs,[132] and Salary Reduction Simplified Employee Pension Plan ("SARSEP") IRAs.[133] Although eligibility requirements, maximum allowable contributions, deductibility of contributions, and taxation of distributions of each of the above IRAs vary slightly, they all share a common characteristic: their current earnings are tax-exempt.[134]

ERISA imposes fiduciary duty standards on qualified plan investments.[135] Under ERISA, each plan must specify one person as a fiduciary—that person can be held personally liable for breaches of ERISA's fiduciary duty standards.[136] A plan fiduciary must administer the plan investments "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[137] In addition, a fiduciary must "diversif[y] the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."[138]

Certain aspects of the scope of the fiduciary duty rule have resulted in RICs becoming an increasingly important investment option for qualified plans and IRAs. First, Congress exempted *individually established* IRAs from most aspects of ERISA, including the fiduciary standards.[139] Second, the ERISA fiduciary rules also do not apply to

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manner as regular IRA); *id.* § 408A(c) (no deduction for contributions); *id.* § 408(d)(1) (no tax on qualified distributions).

130. Coverdell education savings accounts, originally called Education IRAs, were created in the Taxpayer Relief Act of 1997. *See* Taxpayer Relief Act of 1997 § 213(a) (exempting Coverdell education savings accounts from taxation). Contributions to Coverdale accounts are not deductible but the earnings and distributions are tax-exempt to the extent they do not exceed the beneficiary's qualified education expenses. *See* I.R.C. § 530(d)(2).

131. Simple IRAs were created in the Small Business Job Protection Act of 1996. *See* Pub. L. No. 104-188, § 1421(a), 110 Stat. 175 (codified at I.R.C. § 408(p) and amending section 408 to define "simple retirement account").

132. SEP IRAs were created in the Revenue Act of 1978. *See* Pub. L. No. 95-600, § 152(b), 92 Stat. 2763 (codified at I.R.C. § 408(k) and amending section 408 to define "simplified employee pension").

133. A SARSEP is a simplified employee pension set up before 1997. SARSEP IRAs were created in the Tax Reform Act of 1986, but a new SARSEP may not be established after 1996.

134. *See* JOINT COMM. ON TAXATION, *supra* note 118, at 42–49.

135. Employee Retirement Income Security Act of 1974 § 401, 29 U.S.C. § 1101 (2012).

136. 29 U.S.C. § 1109.

137. *Id.* § 1104(a)(1)(B).

138. *Id.* § 1104(a)(1)(C).

139. *Id.* § 1101(a) (ERISA applies only to "employee" benefit plans). Note that in very limited circumstances an IRA offered by an employer may constitute an "employee benefit plan" under ERISA, such as a SARSEP or Simple IRA. *See* 29 C.F.R. § 2510.3-2(d)(1) (2013) (providing safe harbor rules so that the IRA payroll deduction program is not employee benefit

certain self-directed 401(k) plans, so-called 404(c) plans, which must offer a participant the opportunity to exercise control over assets in his account and the opportunity to choose from a broad range of investment alternatives.[140]

For plans subject to the ERISA fiduciary rules, an investment in RIC shares does not make the underlying investments of the RIC "plan assets."[141] Although the RIC shares themselves will constitute plan assets, and the plan fiduciary will be subject to the ERISA fiduciary rules with respect to the RIC shares, the rules will not apply to the investments made by the RICs themselves.[142] Finally, in evaluating whether a fiduciary has discharged his duties, the Act considers whether he has diversified the investment to minimize the risk of large losses.[143]

After Congress created IRAs in 1974, the next, and perhaps most important legislative initiatives for mutual funds, came in 1978 with the enactment of the 401(k) savings plan, a particular type of defined contribution plan.[144] A 401(k) plan is a defined contribution plan that permits contributions by employers and employees to an employee's retirement account. In a defined contribution plan, benefits are based on

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plan).

140. 29 U.S.C. § 1104(c)(1)(A)(ii) ("[F]iduciary shall [not] be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control."). The rules governing 404(c) plans are found in 29 C.F.R. § 2550.404c-1(b)(1). A plan is considered to offer a broad range of investment alternatives if a beneficiary can choose among three investment alternatives each of which is diversified and has materially different risk and return characteristics. *Id.* §§ 2550.404c-1(b)(3)(i)(B)(1)–(2). Although the regulations refer to three investment alternatives, a plan will generally offer at least twenty to thirty alternatives. Moreover, each of the investment alternatives when combined with investments in the other alternatives must tend to minimize through diversification the overall risk of a participant's or beneficiary's portfolio. *Id.* § 2550.404c-1(b)(3)(i)(B)(4). Courts have held that the selection of the fund investments is not subject to the protections of section 404(c). *See, e.g.*, DiFelice v. U.S. Airways, Inc., 497 F.3d 410, 417 n.3 (4th Cir. 2007) (holding that although section 404(c) does limit a fiduciary's liability for losses, losses due to the selection of fund investment are not protected). Various other requirements are found in the cited regulations. *See id.* (noting that it is a "fiduciary function" to limit or designate investment options, and section 404(c) does not insulate fiduciaries from losses stemming from their own poor choices).

141. *See* 29 U.S.C. § 1101(b)(1) (stating that only the RIC shares themselves are "plan assets"); 29 C.F.R. § 2510.3-101(a)(2) (excluding the underlying RIC investments—investments made by the RICs— from the definition of "plan asset").

142. The legislative history to ERISA indicates that Congress believed that "mutual funds are regulated by the Investment Company Act of 1940 and, since (under the Internal Revenue Code) mutual funds must be broadly held, it is not considered necessary to apply the fiduciary rules to mutual funds merely because [pension] plans invest in their shares." H.R. REP. NO. 93-1280 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5077.

143. 29 U.S.C. § 1104(a)(1)(C). Under regulations, it is necessary, but not sufficient, that a manager give appropriate consideration to "composition of the portfolio with regard to diversification." 29 C.F.R. § 2550.404a-1(b)(2)(ii)(A).

144. Revenue Act of 1978, Pub. L. No. 95-600, § 135(a), 92 Stat. 2763.

the amount in the employee's account.[145] In contrast, a defined benefit plan pays benefits based on a formula and from the entirety of plan assets.[146] In a defined benefit plan, a third-party manager (or managers) manages the assets. Whereas, in a defined contribution plan, the plan participant generally controls the investments of his account; hence the importance of defined contribution plans for RICs. In addition, because the contribution limits are much higher for 401(k) plans than for IRAs, the importance of 401(k) assets for RICs will only continue to grow in the future.[147]

The importance of RICs as an investment asset for U.S. retirement savings and the importance of these assets for RICs cannot be overemphasized. What began as a trickle of assets from self-directed retirement plans in 1962 exploded in the 1980s and 1990s with the rise of IRAs, 401(k) plans, and 403(b) plans and the large gains in equity markets worldwide.[148] By the end of 2011, mutual funds were the recipients of $4.7 trillion (about 26%) of the total $17.9 trillion of U.S. retirement assets, and this amount represented 40% of the total assets of all U.S. RICs.[149] Of the $4.7 trillion of retirement assets invested in RICs, $2.2 trillion were held by IRAs and the remaining $2.5 trillion were held by defined contribution plans.[150]

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145. I.R.C. § 414(i) (2012) (defining "defined contribution plan"); *id.* § 414(j) (defining benefit plan as any plan that is not classified as a contribution plan); *see also* JOINT COMM. ON TAXATION, *supra* note 118, at 2–3 (explaining that in defined contribution plans, benefits are based on a separate account for each employee). Contributions to 401(k) plans are generally deductible, and earnings and contributions are exempt from tax until distributed. In 2006, Congress authorized employers to add a qualified Roth 401(k) option to 401(k) plans. I.R.C. § 402A. Contributions to a Roth 401(k) are made with after-tax earnings, but distributions are tax-free if received after age 59.5. *Id.* § 402A(d)(i)(II).

146. Defined contribution plans have surged in popularity since their creation and now have more than three times the number of participants than defined benefit plans. *See* JOINT COMM. ON TAXATION, *supra* note 118, at 75–76 figs.1 & 2 (tracking both active and inactive private sector participants and illustrating a dramatic increase in defined contribution plans).

147. For 2012, total contributions made to an employee's account cannot exceed the lesser of $40,000 or the employee's compensation. I.R.C. §§ 415(c)(1)(A)–(B). The employer's deduction is generally limited to 25% of a participant's compensation. *Id.* § 404(a)(7)(A)(i).

148. Even some traditional providers of pensions, such as state governments, are modifying their plans to include a 401(k) element in order to mitigate unfunded pension liabilities. *See* Jeannette Neumann, *States Shift to Hybrid Pensions*, WALL ST. J., July 10, 2010, at B1 (detailing states' shift towards 401(k) plans in order to alleviate pressure from existing guaranteed pension plans). Consequently, it can be expected that mutual funds will garner in the future an increasing percentage of retirement assets.

149. INV. CO. INST., *supra* note 1, at 124. The $17 trillion consists of $4.9 trillion of IRA assets, $4.5 trillion of defined contribution plan assets, and the remaining $8.5 of private sector defined benefit plan and government pension assets. *Id.* at 107 fig.7.2. Of the $4.9 trillion of IRA assets, $2.1 trillion were invested in RICs. *Id.* at 117 fig.7.12.

150. *Id.* at 125 fig.7.21.

For certain equity funds, tax-exempt investors constitute a significant percentage of fund assets. A recent study of mutual funds estimated for a large sample of equity funds the equal weighted mean of the funds' defined contribution assets was 25%, and the weighted average by AUM was 32%.[151] It should be noted that these percentage are lower bounds for tax-exempt assets, as the study did not include assets of IRAs, Keoghs, etc. Since IRA assets represent a bit less than 50% of the tax-exempt assets in mutual funds, if IRA assets were allocated similarly to defined contribution plan assets, the percentages could be roughly double the percentages reported in the study.[152]

The legislative history of the various retirement savings vehicles discussed above does not indicate that Congress considered any possible negative consequences of permitting retirement savings accounts to co-invest with taxable investors in RICs. Perhaps once Congress decided to permit plan beneficiaries to control their investments, RICs may have been seen as a compelling and safe option—beneficiaries would only select a RIC as a retirement vehicle if it was a desirable investment. In particular, RICs had a long investment track record by the time IRAs and 401(k) plans were authorized. Second, RICs were already subject to extensive regulation under the '40 Act that was intended to provide certain safeguards for small investors, such as mandatory disclosure of material information, NAV pricing for open-end funds, limits on debt,[153] and governance requirements.[154] Third, the redemption requirement at NAV for open-end funds provides investors with liquidity and easy exit from a poorly performing fund and easy entry into a potentially more promising fund.[155] Fourth, and perhaps most

151. Sialm & Clemens, *supra* note 14, at 1404 tbl.1. This means that defined contribution funds were concentrated in larger funds.

152. Craig Copeland, *IRA Asset Allocation*, EMP. BENEFIT RES. INST. NOTES (EBRI Educ. & Research Fund, Washington, D.C.), May 2011, at 9, *available at* http://www.ebri.org /pdf/notespdf/EBRI_Notes_05_May-11.IRA.pdf (concluding that asset allocation in IRAs is similar to that in 401(k) plans; overall percentage in equities for 401(k) plans is 37.4% and 38.5% for IRAs).

153. The debt limitation may not impose an actual limit on economic leveraging by a RIC. Although there are limitations on the amount of debt a RIC may borrow, a RIC could borrow the maximum amount and then invest in other RICs that have also incurred debt.

154. Many commentators have argued that the '40 Act provisions do not sufficiently protect individual investors. In particular, the independence of mutual fund directors has been often questioned. *See, e.g.*, Letter from Warren Buffet, Chairman of the Bd., Berkshire Hathaway, Inc., to Berkshire Hathaway S'holders (Feb. 21, 2003), *available at* http://www.berkshirehathaway. com/letters/2002pdf.pdf (criticizing the purported independence of mutual fund directors).

155. Individual 401(k) or 403(b) plans, however, may impose certain limitations on exiting funds. 29 C.F.R. § 2550.404c-1(b)(2)(ii)(C) (2013). In addition, certain funds may close to new investors, and individual funds may impose redemption fees on short-term shareholders. The fee is intended to dissuade investors from entering and exiting a fund on a short-term basis, which

importantly, Congress appears to have been most concerned with the risks to beneficiaries arising from insufficient diversification, and appears to have believed that the diversification requirements of both the '40 Act and Subchapter M ensured a necessary level of asset diversification. Yet, the diversification requirements provide little protection if a fund is not diversified geographically or across sectors.[156] The recent rise in the offerings of sector-specific ETFs is especially concerning in this regard. Regardless of the benefits for retirement savers of investing in RICs, there is no evidence that Congress had focused on the potential disadvantages to both taxable and tax-exempt shareholders of investing in the same funds.

IV. THE COSTS OF RIC TAXES

The "quasi-pass-through" tax regime applicable to RICs and their shareholders has undoubtedly played a key role in the development of RICs. If RICs were subject to entity-level taxation, dividends distributed by a U.S. corporation whose shares were held by a RIC would bear three levels of tax, and distributions of interest on a bond held by a RIC and capital gains realized by a RIC would be subject to two levels of tax. The extra level of taxation would have certainly reduced the attractiveness of the RIC as an investment vehicle.

As discussed below in Section A, fund taxes can significantly affect after-tax accumulations for taxable shareholders, especially over longer holding periods. Fund managers may therefore adjust the type of assets a fund holds and change realization strategies depending on whether tax-exempt or taxable shareholders own a significant portion of the fund's shares.

When tax-exempt shareholders predominate, a manager may be less concerned with minimizing taxable income, and consequently such funds may generate higher taxable liabilities (and lower after-tax returns) for taxable shareholders. As discussed below in Section B, a recent economic study provides evidence confirming this hypothesis.

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can impose costs on other shareholders by causing the fund to liquidate assets and incur trading costs to satisfy redemption requests.

156. The diversification requirements generally provide some protection against issuer-specific risk. A RIC could satisfy the diversification requirements by investing in many different companies, but if those companies are exposed to the same market risks, for example, the companies are concentrated in a particular industry or a geographic region, the mutual fund may not reap the maximum benefits of diversification, which arises when asset returns are not correlated. There has been an explosion in mutual funds, and in particular, ETFs, that are concentrated in particular sectors. *See, e.g.*, JOHN C. BOGLE, THE LITTLE BOOK OF COMMON SENSE INVESTING 170 (2007) (arguing that sector diversification is insufficient).

Conversely, when taxable shareholders predominate, a manager may engage in trades that are potentially beneficial for taxable shareholders but harmful for tax-exempt shareholders. As discussed below in Section C, because Subchapter M is a partial pass-through regime and does not permit the pass-through of NOLs or NCLs, a fund manager may engage in trades to minimize the present value of these fund-level tax attributes in order to maximize the present value of the benefit of these attributes to shareholders. Such trades may be beneficial for taxable shareholders, but may harm tax-exempt shareholders. Finally, as discussed below in Section D, under Subchapter M, a fund shareholder can be taxed on gains that are realized after the shareholder entered the fund but that economically accrued before the shareholder entered the fund. In such cases, a taxable shareholder's tax liability is accelerated and the present value of his after-tax accumulations is decreased. A fund manager may therefore engage in trades to manage a fund's unrealized gains (known in RIC literature as tax overhang). Again, these trades, although potentially beneficial for taxable shareholders, may harm tax-exempt shareholders.

A. For Taxable Investors, Taxes Can Matter A Lot

It appears that investors, the popular press, and regulators did not focus on shareholder-level RIC taxes until the 1990s.[157] There are several possible explanations for this myopia. First, the distribution requirement ensured that shareholders always received sufficient cash to satisfy tax liabilities attributable to fund distributions. Similarly, redemptions always occur at NAV, which provide sufficient cash to satisfy resulting tax liabilities. Second, RIC asset turnover may have been lower than at present—resulting in lower current tax. For example, the first open-end mutual, the Massachusetts Investor Trust, had an annual asset turnover of approximately 6%, whereas the typical modern equity fund has an asset turnover of more than 80%.[158] Higher asset turnover combined with increasing equity prices generally leads to greater current tax liability. Finally, in periods in which equity returns were high, especially in the 1980s and 1990s, taxes may have been seen as a relatively minor cost, especially since funds advertised pre-tax

157. Joel Dickson & John B. Shoven, *Taxation and Mutual Funds: An Investor Perspective*, 9 TAX POL'Y & ECON. 151, 152 n.1 (noting that before 1993, only *Fortune* published after-tax returns).

158. Daniel Bergstresser & James Poterba, *Do After-Tax Returns Affect Mutual Fund Inflows?*, 63 J. FIN. ECON. 381, 399 tbl.8 (2002) (showing that the mean turnover rate for a large sample of equity funds for 1994–1999 was 80%).

returns rather than after-tax returns.[159] In addition, when fund returns were generally positive and assets increasing, redemption requests may have been low and managers would not need to sell assets to fund redemption requests, whereby generating tax liabilities for other fund shareholders.

Taxable shareholders will generally seek greater after-tax accumulations. The after-tax accumulations of two RICs with identical pre-tax returns will differ based on current tax liabilities; the RIC that generates the lower current tax liabilities will have the greater after-tax accumulation. After-tax returns are a function of the shareholder's holding period, rate of return, discount rate, and tax rates on current distributions and final dispositions. The basic intuition is as follows: if two funds, fund 1 and fund 2, have the same pre-tax return rate, say 10%, but fund 1 generates a current tax liability of 25% and fund 2 a current tax liability of 10%, the assets of fund 2 fund will grow annually at 9% whereas the assets of fund 1 will grow annually at 7.5%. Assuming that when the investment in fund 2 is liquidated and the shareholders pay a 15% tax, because the taxes on a portion of fund 2's gains are deferred, the present value of the taxes will be less and the final accumulation in fund 2 will be greater. The final accumulation of funds 1 and 2 can be represented algebraically as follows:

$$\textit{Fund 1} = X\,[1 + r\,(1 - t_{cur1})]^n \quad \text{(Eq. 1)}$$

$$\textit{Fund 2} = X\,[1 + r\,(1 - t_{cur2})]^n\,(1 - t_{end}) + t_{end}\,\mathrm{X} \quad \text{(Eq. 2)}$$

In this formula, X is the initial investment, r the pre-tax return (10% in the example), t_{cur} the tax rate on current earnings (25% and 10% respectively), n the number of years, and t_{end} (15%) the tax rate on fund liquidation. The last term in Eq. 2 ensures that only gains (and not the initial investment) are taxed.[160]

159. Funds were not required to show after-tax returns until 2001. *See* Disclosure of Mutual Fund After-Tax Returns, Exchange Act Release No. 33-7941, 74 SEC Docket 236 (Jan. 18, 2001) [hereinafter Disclosure of Mutual Fund After-Tax Returns] (requiring mutual funds to disclose after-tax returns in their prospectuses).

160. To show the exact after-tax accumulations, the equations would have to be modified to incorporate the different tax rates applicable to different categories of income. For example, if fund 1's returns consisted solely of short-term capital gains, but fund 2's income consisted solely of NCGs, the t_{cur} of fund 1 would be greater than the t_{cur} of fund 2. In this example, the difference between the t_{cur} of fund 1 and fund 2 is assumed to be attributable solely in differences between realizations of gains and income by the respective funds. In the RIC finance literature, some researchers use a tax rate on unrealized gains of 50% of the statutory rate to calculate after-tax returns. This avoids the problem of having to specify a discount rate to calculate the present value of future tax liabilities. *See, e.g.*, Bergstresser & Poterba, *supra* note 158, at 387–88

The following table shows the after-tax accumulations and after-tax rates of returns for funds 1 and 2 for different holding periods, assuming an initial investment of $1000 and the above taxes and returns. The after-tax rates of return are the annual returns that when applied to the initial investment would yield the final accumulation.

	Assumptions			
X	1000	t_{cur1}	25%	
R	10%	t_{cur2}	10%	
		t_{end}	15%	
Holding Period (n)	5	10	20	30
	After-Tax Accumulation ($)			
Fund 1	1436	2061	4248	8755
Fund 2	1458	2162	4914	11,428
	After-Tax Rates of Return per Period (%)			
Fund 1	7.50%	7.50%	7.50%	7.50%
Fund 2	7.83%	8.02%	8.29%	8.46%

This simple example demonstrates vividly the significant benefits from being able to defer taxes. Because fund 2 is able to reduce its current tax rate from 25% to 10% and defer the final 15% tax, its shareholders increase their after-tax accumulations by over 30% in thirty years. This difference would be further increased if the current income in fund 2 were taxed more favorably than the current income in fund 1.

During the 1990s, the number of mutual funds and AUM exploded, and RICs became an increasingly important investment option for individual investors. As a result, investors, the popular press, Congress,[161] and regulators began to focus on mutual fund costs,

(applying rate of 10%, which was 50% of statutory rate, to unrealized gains to determine after-tax returns).

161. *See, e.g.*, The Mutual Fund Tax Awareness Act of 2000, H.R. 1089, 106th Cong. (2000) (introduced by Congressman Paul Gillmor, passed by the House, as amended, on Apr. 3, 2000, by a vote of 358 to two, and referred to the Senate on Apr. 4, 2000). This bill would have required the SEC to revise its regulations to require disclosure of after-tax returns. *See id.* The Senate did not pass the bill because the SEC already had a regulatory project to require such disclosures.

especially taxes—which researchers have estimated may account for up to one-third of the annual return of an average equity fund.[162] In response to these concerns, the SEC in 2000 revised disclosure rules for RICs to require RICs to disclose after-tax returns.[163] These rules require a RIC to disclose along with its pre-tax returns for one-, five-, and ten-year periods, the after-tax returns for the same periods.[164] Two after-tax returns are required to be shown: after-tax returns computed taking into account solely distributions (pre-liquidation) and after-tax returns taking into account distributions and the sale of the RIC's shares at the end of the respective measurement period (post-liquidation). The post-liquidation taxes would apply to any unrealized gains or losses reflected in a fund's NAV.

After-tax returns are calculated assuming the distributions and gains are taxed at the highest applicable individual federal income tax rate (state taxes are ignored). Pre-liquidation returns are calculated by applying the highest individual marginal tax rate to each type of a fund's distribution, e.g., ordinary income, short-term capital gain, and long-term capital gain.[165] The after-tax amounts of the distributions received are deemed to be reinvested in additional shares of the fund.[166] In addition, foreign tax credits are to be "taken into account in accordance with federal tax law."[167]

162. *See, e.g.*, Bergstresser & Poterba, *supra* note 158, at 390 (estimating that for 1993–1999 for broad-based U.S. equity funds, mean pre-tax return was 19.1% and mean after-tax return 16% resulting in a tax burden of 3.2% or 16% of the pre-tax return); Dickson & Shoven, *supra* note 157, at 160–61 (estimating that for 1963–1992, taxable U.S. investors in certain growth and income equity funds lose 25% of annual returns to taxes); Robert H. Jeffrey & Robert D. Arnott, *Is Your Alpha Big Enough to Cover Its Taxes?*, 19 J. PORTFOLIO MGMT. 15, 22 (1993) (demonstrating that active manager's *alpha* is generally insufficient to cover taxes); Donald J. Peters & Mary J. Miller, *Taxable Investors Need Different Strategies*, 7 J. INVESTING 37 (1998) (approximating that taxes could take from 25% to 32% of pre-tax annual returns for a typical equity mutual fund investor).

163. Disclosure of Mutual Fund After-Tax Returns, *supra* note 159. The Vanguard family of funds began to report after-tax returns in 1999, two years before the SEC required such disclosure. In addition, the Morningstar service also began to report after-tax returns before the SEC rules were finalized.

164. 17 C.F.R. § 230.482(e)(4) (2013) describes the reporting requirements. For a fund that uses a name suggesting that distributions are tax-exempt, either from federal or state, or both, or that implies that the fund is tax-managed must include such figures with any quotation of the company's performance. *Id.* § 230.482(f). The parallel provisions under the '40 Act are found at *id.* §§ 270.34b-1(b)(1)(iii)(B)–(C).

165. Form N-1A, Item 26(b)(1).

166. Form N-1A, Item 26(b)(2), Instructions item 2.

167. Form N-1A, Item 26(b)(2), Instructions item 3. It is not exactly clear how this is to be done. To calculate the applicable foreign tax credit, a taxpayer must calculate the applicable foreign tax credit limitation under section 904(a), which requires determination of a taxpayer's foreign source taxable income and worldwide taxable income. These calculations require in turn

Post-liquidation returns are calculated by assuming a complete redemption at the end of the one-, five-, and ten-year periods and by subtracting any capital gains taxes (or adding any capital gain benefit from capital losses), again using the highest capital gains rate on the date of the deemed redemption.[168] This determination requires a tracking of the basis and holding period of the initial notional $1000 investment and subsequent shares acquired when a fund made distributions.

A RIC does not need to include after-tax return information in a prospectus that is used exclusively for fund shares as investment options in defined contribution plans such as 401(k) and 403(b).[169] The SEC proffered the following rationale for the exemption:

> The proposed after-tax return information would largely be irrelevant in these circumstances because the affected investors either are not subject to current taxation on fund distributions or are not subject to current taxation at the individual federal income tax rates, and their tax consequences on a sale of fund shares are different from those experienced by individual investors in taxable accounts.[170]

Thus, a shareholder who owns shares of a mutual fund through a 403(b) or 401(k) plan does not directly bear the costs of the taxable income generated by the fund, and therefore pre-tax returns should be equal to after-tax returns. However, both tax-exempt and taxable fund investors bear the transaction costs generated by a fund manager's tax-management, which may benefit taxable shareholders but harm tax-exempt shareholders.

B. When Tax-Exempt Investors Predominate

The last two decades have seen an explosion in tax-exempt assets invested in RICs. In 2011, tax-exempt assets represented about 48% of the assets in long-term mutual funds—up from 26% in 1990.[171] As tax-exempt assets come to represent the predominant portion of assets held by many mutual funds, it would be useful to know whether a manager of a fund that has a relatively high percentage of tax-exempt assets may

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a determination of a taxpayer's state taxes, interest expense, and other itemized deductions.

168. Form N-1A, Item 26(b)(3), Instructions item 6–7. A fund may assume that an investor has sufficient capital gains to offset any capital losses. Form N-1A, Item 26(b)(3), Instructions item 7(d). Because the final amount may be increased by the effect of capital losses, it is possible for the after-tax returns of a fund to be greater than its pre-tax returns.

169. Form N-1A, General Instructions (C)(3)(d)(iii). Tax-deferred arrangements under 457, variable contracts as defined in 817(d), tax-exempt foundations, colleges, and corporation are also exempt. *Id.*

170. Disclosure of Mutual Fund After-Tax Returns, *supra* note 159, § E.

171. INV. CO. INST., U.S. RETIREMENT MARKET, FIRST QUARTER 2012 tbl.23 (2012).

be less concerned with managing current ICTI and NCGs and reducing overhang. If the higher ICTI and NCGs are not also accompanied by higher returns, such funds may be inappropriate investment vehicles for taxable investors.

While there has been a significant amount of research on the response of fund managers' investment strategies to changes in the tax laws,[172] there has been surprisingly very little research on whether fund managers invest differently when the percentage of tax-exempt assets under management changes.[173] The results of the most comprehensive study to date of this issue by Sialm and Starks suggest that fund managers do indeed change their investment strategy based on tax clienteles—the tax status of their shareholders—and that these altered investment strategies raise significant issues for *taxable* shareholders.[174]

The percentage of defined contribution ("DC") assets in the sample funds varied greatly, with the lowest DC ratio quartile averaging 4.6% and the highest quartile 54%.[175] Higher DC ratio funds had lower expenses, but had greater AUM.[176] It is important to note that these percentages are lower bounds as the sample did not include IRAs, which represent approximately 50% of the tax-exempt assets in RICs.

Sialm and Starks found that high DC ratio funds had significantly higher annual tax burdens than low DC ratio funds—1.26% versus 1.02% of assets.[177] The difference in annual distributions between high

172. *See, e.g.*, Feng Chen, Arthur Kraft & Ira Weiss, *Tax Planning by Mutual Funds: Evidence from Changes in the Capital Gains Tax Rate*, 64 NAT'L. TAX J. 105, 105–08 (2011) (presenting evidence of tax planning by fund managers in response to changes in tax laws).

173. Susan E.K. Christoffersen et al., *Crossborder Dividend Taxation and the Preferences of Taxable and Nontaxable Investors: Evidence from Canada*, 78 J. FIN. ECON. 121, 141 (2005) (finding that managers with more retirement money favor preferences of tax-exempt investors).

174. Sialm & Starks, *supra* note 14, at 1397–98.

175. *Id.* at 1404 tbl.I. The percentages for the second and third quartiles were 14% and 26%, respectively. The equal weighted mean of the funds' DC assets was 25% and weighted average by AUM was 32%. This means that DC funds were concentrated in larger funds.

176. The low DC ratio quartile had average expenses of 1.28% and the high DC ratio 1.03%. The average AUM of the low DC ratio quartile was $1.4 billion and the high DC ratio $5.6 billion. *Id.* The mutual fund family AUM for the low DC ratio quartile was $28 billion and for the high DC ratio quartile $121.98 billion.

177. *Id.* at 1406 tbl.II. These percentages were calculated by summing the total dividend and capital gain distribution yields multiplied by the *average marginal tax rate*, which is the average of the marginal tax rates where the weights correspond to the declared amounts of dividends and capital gains. *Id.* at 1407. The authors also found that "tax sophistication," which they measured by the average short-term and long-term capital gain distributions, varied significantly between low and high DC ratio funds: 43% of the lowest DC quartile funds exhibited high sophistication, i.e., they distributed annually STCGs below 0.1% and LTCGs below 2.5%, and only 30% exhibited low sophistication (STCGs in excess of 1% and LTCGs above 5%). In contrast, 28% of the highest DC quartile funds exhibited high sophistication and 45% exhibited low sophistication. *Id.* at 1414.

and low DC ratio funds—4.92% and 4.01% of assets—was due mostly to high DC ratio funds distributing a greater percentage of capital gains.[178]

The authors then examined the relationship between total capital gains distributions and certain variables, such as DC ratios, overhang, fund expenses, size, and age. They also found that there was a positive relationship between the DC ratio and total capital gains distributions even when additional variables were added to the regression.[179]

To determine the causality of these results—i.e. to determine whether these relationships are the result of mutual funds adjusting their investment strategies to different clienteles or investors adjusting their asset allocations based on a fund's investment strategy—the authors examined the relationship between total capital gain distributions and (1) the five-year lagged DC ratio and change in DC ratio; and (2) the impact of the 2003 tax reform, which reduced taxes on dividends. The authors again found positive relationships similar to the prior results between the five-year lagged DC ratio and the change in DC ratio, both when the authors tested the variables by themselves and along with other control variables.[180] Thus, fund managers adjusted their capital gain distributions as the DC ratio changed.

Examining the consequences of changes in the tax rate on dividends and capital gains, Sialm and Starks found that low DC ratio funds distributed a smaller percentage of dividends than high DC ratio funds prior to the drop in the dividend tax rate in 2003. After the rate reduction, low DC ratio funds distributed a higher percentage of dividends than high DC funds.[181] Although the ratio of STCGs to total capital gains distributions dropped for both high and low DC ratio funds, the drop was more significant for low DC ratio funds.[182] Both observations suggest that fund managers are at least partially attentive to their tax clienteles.

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178. High DC ratio funds distributed 3.42% in LTCGs and 0.98% in STCGs while low DC ratio funds distributed 2.73% in LTCGs and 0.79% in STCGs. *Id.* at 1406 tbl.II. Dividend distributions were virtually the same, around 0.5%. Because expenses can be subtracted in computing ICTI, which consists of interest, STCGs and dividends, the difference between the distribution percentage of high and low DC ratio funds appears to be due solely to differences of NCGs distributed: the sum of the differences between low and high DC ratio distribution percentages attributable to STCGs and dividends is twenty-four basis points, which is exactly the difference between expense ratios.

179. The coefficient was 0.016 without other control variables and 0.012 with other control variables. *Id.* at 1410 tbl.III.

180. *Id.* at 1411 tbl.IV. The authors note that these results reflect time fixed effects, which are intended to account for time trends in capital gains realizations and DC ratios.

181. *Id.* at 1413 tbl.V panel A.

182. *Id.* at 1413 tbl.V panel D.

The next question they addressed was whether the observed differences in manager investment strategies in response to fund clienteles affected fund returns. The authors hypothesized that those managers who considered the tax efficiency of their fund decisions could face "a more constrained investment opportunity" and consequently generate lower before-tax returns.[183]

Using various return measures,[184] Sialm and Starks found no statistically significant difference in fund performance based on DC ratios. It should be noted, however, that the high DC ratio fund quartile was the best performing quartile in five of the eight return measures, but for only one—the Fama-French-Carhart alpha—was the out-performance significant at the 5% level.[185]

Sialm and Starks present the first detailed analysis of the response of fund managers to different tax clienteles. For taxable investors, the message is clear: avoid high DC ratio funds. Even assuming that the differences in pre-tax returns between equivalent low and high DC ratio funds are insignificant, for taxable investors, taxes represent a significant cost that reduces a shareholder's after-tax accumulations. Sialm and Starks found that taxes represented an annual average cost of 1.09% of assets. To demonstrate the costs of taxes more vividly, Sialm and Starks computed a return history (for 1997–2009) for the 136 funds with a complete return history and calculated the after-tax accumulations using the average marginal tax rates on dividends, STCGs, and LTCGs. For this thirteen-year period, they found that taxes reduced the after-tax accumulations by 13.27%, with an interquartile range of 9.50% and 15.83%.[186] For taxable investors, ETFs and other tax-efficient funds, such as index funds, may be better options than regular mutual funds if their risk-adjusted pre-tax returns are similar.

For tax-exempt investors, the message is not as clear-cut. For the funds in the Sialm and Starks sample, although high DC ratio funds

183. *Id.* at 1416–17.

184. Among the various return performance measures used were monthly raw fund return; objective-adjusted return (fund return minus mean fund return in same CRSP category); style-adjusted return (fund return minus mean fund return in same style classification); alphas based on the CAPM, the Fama and French model, and the Carhart model; and two holdings-based measures. *Id.* at 1417.

185. It is interesting to note that for seven of the eight return measures, the high and low DC ratio fund quartiles outperformed the second and third quartile DC ratio funds. The authors did not comment on this fact, perhaps because many of the data were not statistically significant at the 1%, 5%, or 10% level. These findings, if subsequently confirmed, would suggest that a taxable investor should consider investing in funds in which taxable investors predominate, and tax-exempt investors should invest in funds in which tax-exempt investors predominate, or at a minimum, to avoid funds where neither taxable nor tax-exempt investors predominate.

186. *Id.* at 1417–18.

were the best performing quartile in five of the eight return measures, the out-performance was not statistically significant. The authors state that "[t]his result suggests either that any constraints faced by tax-efficient fund managers do not appear to have costs in terms of lower risk-adjusted returns or that fund managers are not practicing tax-efficiency to the extent it is affecting their before-tax performance."[187]

There may be some explanations for these particular findings. The period covered by the Sialm and Starks study included three periods of high stock price volatility—the dot-com bust of 1999, the 9/11 attacks, and the recession of 2008. Consequently, it may have been relatively easy and inexpensive for a manager to realize losses and thereby reduce ICTI, NCG, and overhang. In addition, sales to fund shareholder redemptions may not have triggered significant gains if a fund held significant shares with built-in losses. Finally, a fund needs to sell to fund redemptions only when net redemptions occur—if acquisitions exceed redemptions on a given day a fund does not have to sell to fund its redemptions. Since over this period RICs experienced a significant growth in assets, RICs may not have been forced too often to liquidate positions to fund redemptions.

An area to explore with future research is whether funds with a very high percentage of DC assets, for instance, 70% or greater, perform better than lower DC ratio funds. In the Sialm and Starks study, the funds in the high DC ratio quartile still averaged about 50% of taxable assets. Those managers may still be somewhat attentive to managing a fund's ICTI and NCGs and may therefore incur costs to manage a fund's income. Conversely, once a fund has a very high percentage of tax-exempt investors, a fund manager may feel less constrained to refrain from liquidating positions (and generating income) and may therefore increase fund turnover, the costs of which offset the benefits of tax planning.

C. Subchapter M as a Partial Pass-Through Regime

The RIC tax regime has been described as a pass-through regime in that a RIC generally does not pay entity-level tax—instead, its income is taxed to its shareholders. In many instances, the tax character of a RIC's income carries over to its shareholders.[188] In certain aspects, however, Subchapter M deviates from a true pass-through regime, under which all entity-level expenses, losses, gains, and income are passed through to the entity's owners and retain their tax character. The

187. *Id.* at 1419.
188. *See supra* Part II.C (discussing the taxation of RIC shareholders).

primary cause for adopting entity treatment appears to be to ameliorate administrative burdens that pass-through treatment would require, for instance, adjusting the basis of RIC shares or filing amended returns. These deviations may be in keeping with the original spirit of the RIC regime by having a relatively simple shareholder-level tax regime for small shareholders, but they may generate tax externalities for both taxable and tax-exempt shareholders.

One way in which Subchapter M deviates from a pure pass-through regime is its treatment of investment expenses, such as management fees. A fund can deduct investment expenses in determining ICTI, i.e., against the fund's STCGs, dividend, and interest income. In contrast, under Subchapter K, such expenses would be separately stated and flow directly to the partners.[189] In some instances, the Subchapter M treatment is beneficial in that it may permit the netting of ordinary expenses against short-term capital gains. In other cases, however, it can be detrimental to a RIC shareholder because investment expenses, potentially deductible at the highest marginal tax rate, are being netted against qualified dividend income, which is taxable at a maximum rate of 20%.[190]

In computing ICTI, a RIC is not permitted to deduct or pass through NOLs.[191] In contrast, regular C corporations are permitted to carry back NOLs to the two prior taxable years and forward to the next twenty years.[192] Under Subchapter K, trade or business losses of a partnership are passed through to the partners.[193] Because of the separate treatment of NCGs and ICTI, a RIC with negative current ICTI and positive NCGs must still distribute the NCGs to avoid entity-level taxation because negative ICTI is not netted against NCGs.[194] For RIC

189. I.R.C. § 701(a)(7) (2012); Treas. Reg. § 1.702-1(a)(8)(i) (2013) (requiring that section 212 expenses must be separately stated).

190. If a mutual fund's investing activities would not otherwise be a trade or business if conducted by a partnership, the management fees would be section 212 expenses and therefore deductible only to the extent that the expenses exceeded 2% of the taxpayer's adjusted gross income. I.R.C. § 67(a). The section 212 limit would similarly apply if the taxpayer owned the assets in an individually managed account and directly incurred the management fees.

191. *Id.* § 852(b)(2)(B).

192. The prohibition against carrying back any NOLs prevents prior year dividends from being recharacterized as a return of capital and requiring amended returns. The leading RIC tax treatise has criticized the prohibition against NOL carryforwards and notes that because many RIC investments can generate ordinary losses, the potential to generate a NOL is much greater than in the past. *See* JOHNSTON & BROWN, *supra* note 69, ¶ 3.06[1][c].

193. I.R.C. § 701(a)(8); Treas. Reg. § 1.702-1(a)(9). The partner must adjust his basis in his partnership interest to reflect the losses passed through. I.R.C. § 705(a)(2). A partnership, however, is not permitted a deduction for NOLs because the losses have already been taken into account by the partners. *Id.*

194. In this case, all of the NCGs are still treated as a dividend and not a return of capital

shareholders, operating losses reduce the fund's NAV and thus will result in a lower gain (or greater loss) upon the sale of fund shares. Because the gain or loss from the sale of RIC shares is generally capital (and assuming that any gain or loss would be long term), any operating losses in essence provide a 20% tax benefit instead of a potential 39.6% tax benefit if the losses could be passed through to taxable shareholders.

A RIC also cannot pass through NCLs—capital losses in excess of capital gains. Instead, NCLs become capital loss carryforwards and can be carried forward for an unlimited number of years.[195] Since NCLs are reflected in NAV, a shareholder only benefits from NCLs when he sells or redeems his shares—his gain is reduced or his loss is increased.

Although a RIC's capital loss carryovers are treated similarly to how they are treated in the hands of an individual shareholder, the presence of a separate, entity-level capital loss carryforward may cause a fund manager to engage in trades that he would not otherwise do in the absence of this rule. If a capital loss carryforward is not used in a given year, its present value declines. For example, using a discount rate of 5%, the present value of a capital loss carryforward in year 8 is only 67% of the year 1 amount; with a discount rate of 7%, it drops to 57%.[196] Thus, a capital loss carryforward is a wasting asset and failure to use it as quickly as possible results in an economic loss to taxable shareholders.

If a fund has a capital loss carryover, a manager will have the incentive to realize gains as any gain realized up to the amount of the carryforward is tax-free.[197] Provided a fund has appreciated assets, it should be relatively easy to realize such gains without significantly affecting the portfolio composition because the appreciated assets can be sold and reacquired almost immediately with any realized gain being recognized for tax purposes.[198]

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because under section 852(c)(1)(B)(i) the E&Ps of the RIC are not reduced by the current operating loss.

195. *Id.* § 1212(a)(3)(A). A partnership separately passes through short-term and long-term capital gains and losses. *Id.* §§ 702(a)(1)–(2).

196. The formula is: $PV = CLCO/(1+ rate)^8$.

197. If the carryforward is short-term, a manager will have an incentive to realize short-term gains rather than long-term gains because if short-term losses are used to offset long-term gains, a fund's NCG, which are taxed at maximum rate of 20%, will be reduced. In contrast, if the short-term losses are used to reduce short-term gains, the losses will offset income taxed at a maximum rate of 39.6%.

198. The presence of the wash sale rule of section 1091 potentially limits the ability to realize a loss but still retain economic exposure to the asset. Under section 1091, if a loss is realized on the sale of stock or securities, the taxpayer cannot require the asset until thirty-one days have passed. *Id.* § 1091(a). There is no wash "gain" limitation, even for fungible assets, such as shares of a company. Thus, shares of IBM can be sold and provided that the identical shares sold

It is important to note that there is not necessarily any relationship between realized gains and losses and NAV, since NAV is calculated on a mark-to-market basis. Thus, realized taxable gain or loss has already been reflected in NAV, and subsequent tax-motivated trades should not affect NAV. Since recognized losses will either reduce short-term gains (and ICTI) or long-term gains (and NCG), required distributions and shareholder taxable income will both also be reduced.

Permitting the carrying back of operating losses or passing through capital or net operating losses would be administratively burdensome for shareholders as they could be required to file amended returns or to adjust the basis of their fund shares as is required under Subchapters K and S.[199] It is administratively burdensome to adjust the basis of shares of a RIC given the large number of RIC shareholders and because a RIC shareholder typically owns many different blocks of shares, each with a different basis.[200] In addition, there is no simple method to allocate any carried back losses among the prior-year shareholders.[201]

The existence of net operating losses or capital loss carryforwards creates an incentive for a fund manager to realize gains to use the losses as quickly as possible. Also, if a fund manager observes that the fund may generate operating losses, he will have an incentive to realize gains to offset the losses. Such tax driven trades, which may be beneficial for taxable shareholders, generate no benefits for tax-exempt shareholders, but tax-exempt shareholders bear their share of the costs of such trades.

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are not reacquired, the sale should be respected for tax purposes, even if the sale and reacquisition occur almost simultaneously. Somewhat surprisingly, even very large funds sometimes fail to use relatively small capital loss carryforwards. *See, e.g.*, Vanguard Index Funds, Annual Report (Form N-CSR) (Feb. 25, 2011) (listing, for the Vanguard Index 500 Fund, gains of $1.2 billion and net assets of $102.6 billion, but having a capital loss carryforward of a comparatively paltry $293.9 million, expiring at the end of 2014).

199. *See* I.R.C. § 705(a)(2)(A) (requiring partners to reduce basis in partnership interest by loss); *id.* § 1367(a)(2) (requiring the same for shareholders of S corporations).

200. Each share of a corporation has a separate basis. Each time a RIC shareholder receives a distribution and elects to reinvest the distribution, which approximately 90% of the RIC shareholders do, the reinvested shares have a basis equal to NAV at the time of reinvestment. If a shareholder receives a distribution that is a return of capital, the basis of each shareholder would have to be reduced. Under proposed regulations under section 301(c), it is possible to have gain on some shares but not on others when a distribution constitutes a return of capital. *See id.* § 301(c); Prop. Treas. Reg. § 1.301-2, 74 Fed. Reg. 3509-3513 (Jan. 21, 2009).

201. Under Subchapter K, when a partner's interest in a partnership changes during the year, his distributive share of partnership items must be determined by taking into account his varying interest in the partnership. I.R.C. § 706(d)(1). A partner's interest can be determined by either closing the books or prorating partnership items. Treas. Reg. § 1.706-1(c)(2)(ii) (2013). Special rules apply to expenses of cash basis items. *See* I.R.C. § 706(d)(2).

D. Taxable Investors and Other Peoples' Gains and Losses

A RIC generally avoids entity-level taxation by distributing all of its ICTI and NCGs. Since tax-exempt shareholders are not subject to tax on the distributions, it would appear that they would care about a RIC's economic income but be indifferent to a RIC's taxable income. Part IV.B showed that when tax-exempt shareholders predominate, mixing tax-exempt and taxable investors generates tax externalities for taxable investors.[202] When taxable shareholders predominate, the RIC tax regime may generate tax externalities for tax-exempt investors. The prior Section focused on certain aspects of the partial pass-through regime of Subchapter M that may result in managers effecting trades solely to eliminate entity-level current operating losses and capital loss carryforwards. This Section focuses on managers' actions to reduce ICTI and tax overhang, handling redemption requests of other fund shareholders, and complying with distribution and other tax-related requirements.

A fund generates income or loss when the fund manager decides to sell (or hold) particular assets: gains and losses arise from the sale of investment assets, such as stocks, bonds, options, forwards, and futures and income arises from dividends and interest received from stocks and bonds. A fund manager may unilaterally decide to sell to change the composition of the fund portfolio, manage the fund's ICTI or NCGs, or raise cash to fund shareholders' redemption requests.[203]

Given the significant costs that taxes can represent, a fund manager's ability to defer fund gains and shareholder taxes can materially increase shareholders' after-tax accumulations. This suggests that taxable shareholders may avoid funds with high tax burdens. Since fund managers are generally compensated on the basis of AUM,[204] they will have an incentive to minimize ICTI and NCGs so as to attract more

202. *See supra* Part IV.B (discussing the tax consequences generally when tax-exempt shareholders predominate).

203. A fund could also realize income or loss involuntarily, for example, when a company is acquired in a taxable transaction, a company is liquidated, its bonds become worthless, or its bonds are redeemed.

204. Daniel N. Deli, *Mutual Fund Advisory Contracts: An Empirical Investigation*, 57 J. FIN. 109, 115 (2002) ("We find that 4,833 (93 percent) of the funds had advisory contracts based solely on a percent of assets."); Jerold B. Warner & Joanna Shuang Wu, *Why Do Mutual Fund Advisory Contracts Change? Performance, Growth, and Spillover Effects*, 66 J. FIN. 271, 274 (2011) (explaining that "in over 90% of the equity mutual fund advisory contracts, the fee is specified as a percentage of TNA"); *see also* Edwin J. Elton, Martin T. Gruber & Christopher R. Blake, *Incentive Fees and Mutual Funds*, 58 J. FIN. 779, 780–81 (2003) (discussing the minimal use of incentive fees in mutual funds, specifically that incentive-fee funds represent a miniscule percentage of total bond and stock mutual funds and a small portion of their assets).

assets.[205] Consequently, it is in the interest of both managers and *taxable* shareholders to execute trades (or avoid executing trades) in order to minimize ICTI and NCGs.

There is an extensive finance literature that has found a positive relationship between *pretax* returns and fund inflows.[206] It appears that mutual fund investors are indeed return chasers.[207] Bergstresser and Poterba, examining a large sample of equity fund returns over the 1993–1999 period, found that net, new money inflows were positively related to a fund's pretax return. In particular, a 100 basis point increase in a fund's return was associated with a 1.2% to 2.6% increase in fund inflows.[208]

It further appears that investors look beyond a fund's pretax return and are sensitive to a fund's tax burden. When a fund's tax burden was taken in account, the same study found that a 100 basis point increase in a fund's tax burden was generally associated with a *decrease* in net, new-money fund inflows with estimates ranging from 1.9% to 8.5%.[209]

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205. Also, as AUM increase, the management expenses per dollar of AUM should decline as fund costs are fixed—i.e., when fund assets double, fund costs do not double—and thereby increase a fund's pre-tax returns. Alas, this has not been the case in the United States. *See, e.g.*, Burton G. Malkiel, *Asset Management Fees and the Growth of Finance*, 27 J. ECON. PERSP. 97, 99 tbl.1 (2013) (noting value of equity assets rose 135 times from 1980 to 2010, but expense ratio increased 50%).

206. *See, e.g.*, Richard A. Ippolito, *Consumer Reaction to Measure of Poor Quality: Evidence from the Mutual Fund Industry*, 35 J.L. & ECON. 45, 47 (1992) (suggesting the mutual fund market easily enables investors to accurately compare market shares and investment returns); Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1619 (1998) (discussing research that suggests "consumers flock to high performing funds"); Vincent. A. Warther, *Aggregate Mutual Fund Flow and Security Returns*, 39 J. FIN. ECON. 209, 233 (1995) (discussing research that has demonstrated investors examine performance of individual funds before deciding whether to invest in those funds).

207. This is even the case although it has been demonstrated that there is little persistence in fund returns. Mark Charhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 57–58 (1997). It has been argued that this may be rational behavior on the part of investors. Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269, 1270 (2004).

208. Bergstresser & Poterba, *supra* note 158, at 402–04. These estimates are obtained from regressions relating funds inflows to certain variables, including pre-tax returns, tax burdens, style indicators, lagged fund flows, and capital gain overhang. The estimates are determined using average returns and returns adjusted by one and three factors. The coefficients were negative for all of the returns (implying a decrease in fund inflows when the tax burden increases) except for one result when "year-specific style effects" was not included and three-factor return adjustment was used. The authors attribute this as suggesting "changing tastes for different types of funds." *Id.* at 404. Return chasing can help a fund increase tax efficiency: new contributions can be used to fund redemptions and thereby reduce the need to sell fund investments (and thereby generate capital gains).

209. *Id.* The authors note that there are other explanations besides tax awareness that could account for their findings of a negative relationship between fund inflows and tax burdens. In particular, they note the growth in index funds, which generally have relatively low tax burdens.

In addition, the same study found that the impact of the tax effect was generally greater in the later years of the period studied.[210] The authors of the study attribute this effect to the greater awareness among the investing public of the tax consequences of investment in mutual funds. It should be noted that the period for which the returns were collected in this study preceded the date the SEC began to require disclosure of after-tax returns.

In addition to current tax burdens,[211] taxable investors appear to be concerned with a fund's future tax burden. There appears to be some persistence in tax burdens. That is, a fund that has been tax (in)efficient in the past will continue to be tax (in)efficient.[212] In addition, future tax burdens can arise from a fund's unrealized gains (overhang). Realization of gains to reduce overhang can accelerate a shareholder's taxes and reduce after-tax accumulations.

Various researchers have found that larger capital gain overhang is associated with smaller fund inflows.[213] Bergstresser and Poterba, for example, found that an increase of 10% in a fund's overhang *decreased* new money net inflows between 1.7% and 2.3%.[214] Because of the concern of taxable investors with overhang, fund managers appear to take steps to manage a fund's overhang, such as strategically realizing losses and gains or being forced to realize gains to fund redemption requests.[215] Current fund income could be increased, but future fund income (and fund overhang) would be decreased.[216] The costs incurred

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Id. When the regressions were run without including index funds, all of the coefficients were smaller but still statistically significant. *Id.*

210. *Id.*

211. *See id.* (most regressions were run using lagged tax burdens of one and two periods).

212. *Id.*

213. *See, e.g.*, Barclay, Pearson & Weisbacet, *supra* note 112, at 33; Bergstresser & Poterba, *supra* note 158, at 405 ("If taxable investors are concerned about purchasing shares in a fund that might realize gains and thereby burden them with higher taxes, a larger capital gain overhang could be associated with smaller fund inflows.").

214. Bergstresser & Poterba, *supra* note 158, at 406 tbl.10. The mean unrealized capital gain of the funds in the study was 26%. *Id.*

215. *See* Barclay, Pearson & Weisbacet, *supra* note 112, at 30 (finding evidence that managers reduce overhang to attract new investors). Redemptions requests are generally paid in cash, but may be paid in-kind with the distribution of securities. *See infra* note 221 and accompanying text (discussing the surprising combination of taxable gains and significant economic losses in fund shares). Funds generally keep a cash reserve, but if the redemption requests are significant, the fund may have to liquidate assets and thereby trigger taxable gain.

216. There is an argument that managing fund overhang may be beneficial to tax-exempt investors: if managing fund overhang increases fund assets, management costs, which are largely fixed, would then be spread over more assets with the result that costs as a percentage of assets would be reduced. Some commentators have noted, however, that increases in fund size generally have not resulted in a lower percentage of management expenses. *See, e.g.*, JOHN BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM 154 (2005) (noting that management fees

to reduce and manage fund overhang, however, do not provide any benefit for tax-exempt shareholders.

For a fund with a significant percentage of assets held by tax-exempt investors, a fund manager may be less concerned with managing fund overhang. Since tax-exempt investors are not concerned with future fund taxes, they may not monitor a fund's overhang. This could be a concern for taxable investors as a manager may be less concerned with realizing gains and increasing the current tax burdens of taxable shareholders.[217]

A fund's overhang or built-in gain ("BIG") is important to potential new investors because its *reduction* can lead to an acceleration of a shareholder's tax liability and a reduction in after-tax accumulations.[218] A fund's ICTI and NCG are allocated to shareholders on the record date,[219] but ICTI and NCG allocated to a shareholder do not necessarily correspond to the economic gain or loss the shareholder has with respect to his fund shares. Consequently, a shareholder can be allocated and taxed on gains that economically accrued (but that have not been recognized for tax purposes) prior to the acquisition of his fund shares.

Example 1: New Shareholders Taxed on a Fund's BIG

Assume that a fund has one shareholder owning one share with an NAV and built-in NCG of $100. Now assume that a new shareholder purchases an additional share for $100. The fund's NAV will remain at $100 ($200, divided by two shares). If the fund immediately realizes and distributes the $100 of NCG, the new shareholder will be allocated 50% of the NCG, and the fund's NAV will drop to $50 ($100, divided by two shares). The new investor has been taxed on 50% of the fund's NCG,

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and operating fees have dramatically increased between 1950 and 2004); Malkiel, *supra* note 205, at 97–98 (concluding that fees have risen substantially as a percentage of assets managed and represent deadweight loss for investors).

217. Sialm and Starks had found that high DC ratio funds were significantly less likely to realize short- and long-term capital losses. Sialm & Starks, *supra* note 14, at 1415–16.

218. Morningstar, the most popular mutual service vendor, provides detailed analyses of each fund's tax burdens, including overhang. Morningstar displays tax-adjusted returns for its funds following the SEC guidelines and ranks funds in the same Morningstar category based on the fund's tax-adjusted total return. It also displays a fund's tax cost ratio, which is the percentage reduction in annualized (pre-tax) return from taxes. *See Morningstar Report: Mutual Fund Data Definitions*, MORNINGSTAR, http://www.quicktake.morningstar.com/DataDefs/FundTotalReturns.html (last visited Jan. 31, 2014) (providing definitions of and discussing Morningstar's mutual fund data). *But see* Russel Kinnel, *Tax-Managed Funds are Dead; Long Live Tax Management*, MORNINGSTAR, (June 26, 2006), *available at* http://www.news.morningstar.com/articlenet/article.aspx?id=167156 (suggesting investors do not care about tax-managed funds).

219. Equity funds generally distribute ICTI and NCG annually.

> even though all of those gains economically accrued before his entrance into the fund.

The new investor will still have a basis of $100 in his fund shares, and could realize the built-in loss by redeeming his shares. If the shareholder has not held the fund shares for more than one year, any loss will be short-term, except if the fund has been held six months or less, in which case it will be treated as a long-term loss.[220] If the shareholder does not have other short-term losses, the loss will end up offsetting the NCG distributed by the fund. This is tax inefficient as the short-term loss could otherwise offset income taxed at 39.6%, but instead will reduce income taxed at 20%. If, however, the shareholder does not elect to exercise his option to sell the fund shares—perhaps because he strongly believes in the ability of the fund manager to generate above-market gains—he will have accelerated his tax liabilities and therefore diminished his after-tax accumulations.

The issue of shareholders being taxed on gains that accrued prior to purchasing fund shares was highlighted during the steep drop in the value of equities in 2008. Many fund investors were shocked to discover, much to their chagrin, that they had taxable gains—caused by the funds liquidating investments with low bases to satisfy redemption requests—but significant economic losses in their fund shares.[221] This

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220. Under section 852(b)(4)(A), certain losses on the sale of the mutual fund shares that would otherwise be short-term are reclassified as long-term. I.R.C. § 852(b)(4)(a) (2012). These rules are designed to prevent certain strategic trading of mutual fund shares. Assume that a shareholder has $100 of short-term capital gains, and a RIC has announced that it will distribute capital gain dividends next week to all shareholders of record as of this Friday. The shareholder would purchase enough RIC shares to ensure that when the dividend was paid, he then would receive a NCG dividend equal to the short-term capital gain—$100—and then would sell the shares shortly thereafter at a loss of $100 (the amount of the dividend). The prior short-term gains and losses from the sale of the RIC shares would be netted, and the shareholder would have $100 of long-term capital gain. If left unchecked, these trades would be a relatively easy way to convert short-term capital gains to long-term capital gains, thereby converting a tax of 39.6% on $100 to a tax of 20%. Section 852(b)(4)(B) addresses a similar arbitrage with respect to tax-exempt dividends.

221. *See, e.g.*, Dave Carpenter, *A Surprise Tax Hit for Even Money Losing Investors*, WASH. POST, Nov. 16, 2008, http://www.washingtonpost.com/wp-dyn/content/article/2008/11/15/AR2008111500186.html ("A required year-end practice by mutual funds is about to whack many people with capital gains taxes at the cruelest of times: when funds already have declined by as much as 40 percent this year. Even though a fund's value has declined, it may have realized capital gains over the course of the year—profits from selling specific securities in the portfolio."); Sam Mamudi, *Investing in Funds: A Monthly Analysis*, WALL ST. J., Dec. 1, 2008, at R1 ("Fund shareholders are facing the double whammy of negative returns plus, at some funds, a tax bill caused by fund managers unloading assets to cover redemptions. Along with swallowing losses exceeding 40% on many stock funds, some fund investors will get year-end capital-gains distributions on which they'll have to pay 15% tax."); Jeff Plungis & Sree Vidya Bhaktavatsalam,

issue has received significant discussion in the academic literature and financial popular press, but the solutions proffered would require significant changes to Subchapter M and other fundamental tax provisions, such as deferring tax on reinvested gains, or adopting certain administratively complex concepts from Subchapter K discussed below in Part V.B.[222] To date, Congress has not been receptive to implementing any of these ideas.[223]

Subchapter M itself contains a unique relief valve that funds can use to strip out tax free appreciated assets and thereby reduce overhang. When an investor redeems his fund shares, the redemption request is typically satisfied in cash. It can be satisfied, however, by a distribution in kind of securities of the fund.[224]

Year-end Mutual Fund Tax Bite May Spark ETF Growth, BLOOMBERG (Nov. 11, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aEWMVQanw4SY ("Record mutual-fund withdrawals have forced managers to sell their profitable stocks to meet redemption requests, triggering distributions. The tax bill will arrive even if the fund had terrible annual returns."). If a shareholder's tax liabilities were significant, the shareholder could be forced to redeem more shares to pay the liabilities, thus potentially leading to a vicious circle of redemptions.

222. *See infra* Part V.B (discussing provisions from Subchapter K that mitigate temporary taxation of economic gains or losses).

223. *See generally, e.g.*, John V. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds*, 1 J. LEGAL ANALYSIS 591, 614–18 (2009) (discussing a wide array of mutual fund reforms); Shawn P. Travis, *The Accelerated and Uneconomic Bearing of Tax Burdens by Mutual Funds Shareholders*, 55 TAX LAW. 819 (2002) (detailing scenarios under which Subchapter M can result in acceleration of tax for fund shareholders and arguing that fund shareholders should not be taxed on reinvested capital gains, but only when shares are sold or non-capital gain dividends received); Samuel L. Brunson, *Mutual Funds, Fairness, and the Wealth Gap* 24–25 (Loyola Univ. Chi. Sch. of Law Pub. Law & Legal Research, Paper No. 2012-013, 2012) (recommending that investors be able to exclude up to ten percent of their dividend income from mutual funds from the investors' taxable income); Mary Beth Franklin, *Year-end Tax Moves for 2011*, KIPLINGER (December 2012), http://www.kiplinger.com/magazine/archives/year-end-tax-moves.html (warning fund shareholders to avoid purchasing funds prior to the record date in order to prevent acceleration of income tax from fund distributions).

224. Section 11 of the Investment Company Act of 1940 states that RICs may not offer to exchange their securities for anything other than their NAV without SEC approval. 15 U.S.C 80a-11 (2012). The corollary is that the SEC can approve such transactions on a case-by-case basis. *See* Exchange Traded Funds, Securities Act Release No. 8901, Investment Company Act Release No. 28,193, 73 Fed. Reg. 14,618, 14,618–19 (proposed March 18, 2008); William A. Birdthistle, *The Fortunes and Foibles of Exchange-traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 86–88 (2008) (discussing the case-by-case approval process used by the SEC). In 2008, the SEC had proposed to codify this case-by-case process, allowing all funds that meet certain requirements to become ETFs. Exchange Traded Funds, 73 Fed. Reg. at 14,619. However, this rule was not adopted. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-end Management Investment Companies, Securities Act Release No. 8998, Investment Company Act Release No. 28,584, 74 Fed. Reg. 4546, 4558 n.161 (Jan. 26, 2009) (to be codified at 17 C.F.R. pts. 230, 232, 239, 274). Under basic corporate tax provisions, the shareholder-level tax effects are the same if a shareholder receives property or cash in redemption of his shares: gain or loss is recognized based

Generally, if a C corporation distributes property to its shareholders, it must recognize any built-in gain (but not loss) in the distributed property.[225] A RIC, however, can distribute appreciated securities without recognizing gain if the distribution is in redemption of its stock upon the demand of the shareholder.[226] The fund shareholder will recognize gain or loss based on the difference between his basis in the shares and the value of the distributed securities and will take a FMV basis in the distributed securities.

<u>Example 2: Tax-Free Distribution of Property</u>

> A RIC has one shareholder with a basis of $100 in his RIC share with an NAV of $200, and the RIC owns an asset with a basis of $100 and a FMV of $200. New shareholder contributes $200 to the RIC in exchange for one share. Shortly thereafter, new shareholder redeems its share for $200, and the RIC distributes the appreciated property to the shareholder. The RIC will not recognize any gain on the distribution of the appreciated property, and the shareholder will not recognize any gain upon a sale of the appreciated property at $200. The entire built-in gain in the distributed property will therefore escape taxation at the RIC level, and the redeemed property would have a FMV basis in the hands of the redeemed shareholder.

If the initial investment in the RIC was made at an NAV that approximates the FMV of the distributed property, the gain in the distributed property will be entirely eliminated, as the redeemed investor will only have taxable gain to the extent that the FMV of the received property exceeds its basis in its redeemed shares.[227]

Note the different result if the new shareholder were tax-exempt, the fund sold the appreciated asset for $200, recognized the built-in gain of $100, and distributed $200 of cash (instead of distributing the appreciated property) to the tax-exempt investor in redemption of its shares. At year-end, the original (and remaining) shareholder would have been taxed on (and presumably received) $100 of capital gains. The fund would still have $100 of assets ($200 - $100 of NCG dividend) and the fund's NAV would be $100.

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on the difference between the value of the property or cash received and the basis in his shares.

225. I.R.C. § 311(b).

226. *Id.* § 852(b)(6).

227. The tax on the economic gain ($100) is preserved because the original shareholder will be taxed when he redeems his shares.

With tax-exempt investors, this provision could be a mechanism to clean out a fund's built-in gains, regardless of the amount of the investment.[228]

Example 3: Fund Distributes Property to Tax-Exempt Shareholder

Assume the same facts as previous example, except that the RIC has an NAV of $1000 and ten assets, each with a basis of $10 and a FMV of $100. New *tax-exempt* shareholder contributes $500 to the RIC in exchange for a one-half share. Shortly thereafter, tax-exempt shareholder redeems its one-half share for $500, and the RIC distributes half of the appreciated assets to the tax-exempt shareholder. This can be repeated until there are no gains left.

There are many possible variations that have a similar effect as the distribution of appreciated securities. For example, a tax-exempt investor could make a very large investment immediately before the record date and then redeem its shares shortly thereafter.[229] If the investment were large enough, the tax-exempt investor could be allocated a significant portion of the fund's gains and thereby reduce the taxable investors' taxable income.

Example 4: Tax-Exempt Shareholder Invests Before Record Date

Assume the same facts as Example 1, except that the new shareholder, a *tax-exempt* shareholder, invests $900 in exchange for nine shares immediately before the record date. The fund had previously sold its sole asset for a gain of $100, which will be distributed to fund shareholders as of the record date. The $100 is distributed $^{1}/_{10}$ and $^{9}/_{10}$ between the tax-exempt and taxable shareholder.

In the absence of legal frictions, it should be possible for the tax-exempt and taxable shareholders to share the benefits from removing appreciated assets from a RIC or absorbing a significant portion of a RIC's ICTI or NCGs. One simple mechanism would be to permit the tax-exempt investor to enter the fund at a discount, exit at a premium, or

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228. It appears that this provision is being exploited by financial entrepreneurs. *See Redemption In-Kind*, REFLOW, http://www.reflow.com/redeminkind.htm (last visited Feb. 9, 2014) (cash contributed by Reflow is used to redeem large shareholder and appreciated securities are in turn distributed to Reflow).

229. To guard against changes in the value of the RIC shares, an investor could consider hedging.

pay reduced expenses. Certain legal frictions may prevent this; for example, the '40 Act requires that open-end funds sell and buy their shares at NAV.[230]

The IRS has issued numerous rulings permitting distributions of appreciated securities to shareholders of both open-end and closed-end funds.[231] One of the required representations to obtain a private letter ruling appears to be that the fund distribute a pro rata share of each of its securities (subject to certain exceptions, e.g., restricted and unregistered securities), and the ratio of the aggregate tax basis of the distributed securities to the total aggregate tax basis of the RIC's securities is approximately equal to the percentage of the RIC's securities being distributed.[232] This requirement ensures that a redeeming shareholder can only take a proportionate amount of unrealized appreciation from the RIC.[233] If the redeeming investor is a tax-exempt investor that is being affirmatively used to extract appreciated securities, however, this requirement does not prevent the untoward extraction of built-in gains.

The representations in the letter rulings do not seem to be required by the statute or regulations, and it is not clear why a fund would need to apply for a ruling for a transaction that clearly falls within the scope of the statute. There is some question whether section 852(b)(6) is intended to apply exclusively to open-end funds, but the statute is certainly not limited to open-end funds, and the IRS has issued letters to closed-end funds allowing them to avail themselves of this provision. Not surprisingly, section 852(b)(6) has been subject to criticism, and there have been calls for its repeal.[234]

230. 15 U.S.C. § 80a-22(c) (2012) (authorizing the SEC to create rules on distribution and redemption prices, regarding NAV); 17 C.F.R. § 270.22c-1(a) (2013) (setting the price for distribution and redemption of a RIC's shares to its NAV).

231. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2005-09-013 (Nov. 17, 2004) (permitting distributions of appreciated securities to requesting shareholders from both open-end and closed-end funds).

232. *See, e.g.*, *id.* ("[S]ecurities distributed will have an aggregate tax basis that, as a percentage of the Fund's aggregate tax basis in all its assets prior to the redemption, is no more than 1 percentage point lower than the percentage of the assets that are being distributed by the Fund."). One ruling states that following this approach, a redemption will "neither defer the recognition of gain to Fund's nonredeeming shareholders nor permit the disproportionate deferral of tax at Fund's level." I.R.S. Priv. Ltr. Rul. 2004-14-043 (Apr. 2, 2004); *see* Signature Financial Group, Inc., SEC No-Action Letter, 1999 WL 1261284, at *6 (Dec. 28, 1999) (recommending that no action be taken where mutual fund distributes pro rata its portfolio securities to an affiliated party in response to a redemption request, regardless of whether that party is a RIC).

233. For example, applying the approach of the rulings to the facts in Example 3 above, since 50% of the assets are being distributed ($200/$400), the fund could distribute securities with an adjusted basis equal to $150, which is equal to 50% of the total aggregate tax basis of the RIC's securities (the sum of $100 of the original securities and $200 of the contributed cash).

234. *See, e.g.*, Lee A. Sheppard, *ETFs as Tax Shelters*, 131 TAX NOTES 1235, 1240 (2011)

This provision is a key factor for the extreme tax efficiency of ETFs as they use it to distribute low basis property to large, redeeming shareholders and thereby strip out almost all appreciated assets and consequently any future gains.[235] For instance, for taxable year 2012, in one large ETF family, iShares, only two of the funds recognized any capital gains.[236] Congress does not seem to be concerned with RICs distributing property tax-free, and the SEC believes that at least with respect to ETFs, the redemption provision helps ensure that that the publicly traded price of the ETF will not diverge significantly from the NAV of the ETF, thereby alleviating the problem that oftentimes plagues closed-end funds of share prices trading at a discount or premium to a fund's NAV.[237]

In addition to the problem of overhang, which can result in the allocation to new fund investors of taxable gains that accrued before the investors entered the fund, the separate treatment of fund-level gains and shareholder-level gains can result in the acceleration of taxable gain as the same gains can be taxed temporarily to both departing and current shareholders.

Example 5: Double Taxation of the Same Economic Gain

Shareholders 1 and 2 each invest $100 into fund, which purchases an asset for $200. During the next two years, the asset appreciates to $300. Shareholder 2 redeems his share for $150, which fund satisfies by selling the asset and distributing $150 to Shareholder 2. At end of year 2, fund will distribute $100 of NCG to Shareholder 1, and Shareholder 2 will be taxed on $50 of gain, the difference between his initial investment and amount received at redemption.

(criticizing the section 852(b)(6) loophole and its protection by the fund industry).

235. *See, e.g.*, Robert Gordon, *When ETFs Pass Along Gains*, INVESTMENT NEWS(Feb. 11, 2008), www.twentyfirst.com/pdf/Investment_News/2008/when_etfs_pass_along_gains_IN_feb11_2008.pdf ("[D]istributions in kind are the linchpin of ETFs; an entire industry has been built on the distribution-in-kind 'glitch.'"). The redemption option is only available to large shareholders.

236. BLACKROCK, ISHARES 2012 DISTRIBUTIONS—YEAR END TAX SUPPLEMENTAL REPORT (2012), *available at* http://us.ishares.com/content/stream.jsp?url=/content/en_us/repository/resource/tax/2012_distribution_summary_information.pdf.

237. Exchange Traded Funds, Securities Act Release No. 8901, Investment Company Act Release No. 28,193, 73 Fed. Reg. 14,618, 14,620 (proposed Mar. 18, 2008) ("The ability of financial institutions to purchase and redeem creation units at each day's NAV creates arbitrage opportunities that may help keep the market price of ETF shares near the NAV per share of the ETF.").

In this example, there is $100 of taxable and economic gain that accrued to and should be taxed equally to both Shareholders 1 and 2. Because NCGs are allocated only to the shareholders of record, all of the NCGs realized by the fund are taxed to Shareholder 1, but Shareholder 2 is also taxed on his share of the of NCGs ($50) when he redeems his shares. Thus, Shareholder 1 is paying tax on $50 of NCG that is economically attributable to Shareholder 2 and on which Shareholder 2 was taxed when he left the fund. Because the fund's NAV is $50 ($300 - $150 (Shareholder 1) - $100 (NCGs)) and Shareholder 1's basis is $100, when he sells his shares, he will realize a loss of $50 that can be used to offset the $100 of NCGs on which he was taxed. If, however, he does not sell his shares, his taxable gain is accelerated and his after-tax accumulation is reduced. Also, if he sells his shares the following year and does not have sufficient gains to offset the loss, the loss must be carried over to subsequent years until the shareholder has sufficient gains to offset the loss.

This example also highlights how redeeming shareholders can impose costs on remaining shareholders. When an investor wishes to redeem his RIC shares, the RIC generally must return cash (or securities) equal to the fund's NAV. Small redemptions can be handled with the cash retained by a fund, but larger redemptions eventually require a fund to liquidate investments to generate cash.[238] A fund's selling activity to meet redemption requests potentially generates three costs. First, the actual sales will entail brokerage fees.[239] Second, sales of shares are sold at the bid price and thereby generate sales costs.[240] Finally, when a fund sells shares to satisfy a redemption request, the shares sold by the RIC may generate taxable gain and thereby increase a fund's ICTI or NCG. An increase in either ICTI or NCG generates taxable income for taxable shareholders and thereby increases administrative and compliance costs. Either taxable or tax-exempt investors can initiate redemptions, but taxable investors appear to redeem more frequently than tax-exempt investors.

238. To the extent that a fund has daily inflows greater than outflows, there is no need to sell assets to fund redemptions.

239. Richard Edelen, Richard Evans & Gregory Kadlec, *Shedding Light on "Invisible" Costs: Trading Costs and Mutual Fund Performance*, 69 FIN. ANALYSTS J. 33, 35–36 (2013) (discussing and defining brokerage cost).

240. *Id.* at 36 (discussing and defining bid-ask spread cost). In addition to brokerage commissions and bid-ask spreads, a fund's buying and selling will cause the price of the share to increase or decrease with each buy or sell order. This is referred to as "price impact," and it can be greater in magnitude than commissions and bid-ask spreads. *Id.* at 36–37 (discussing and defining price impact cost).

The prior examples illustrate how Subchapter M can potentially result in a temporary acceleration of gains when a shareholder redeems and recognizes gains and those same gains when realized by a fund are distributed to current shareholders. Subchapter M can also permit the temporary duplication of losses.

Example 6: Temporary Duplication of Losses

> Assume that Shareholders 1 and 2 each invest $100 into fund, which purchases an asset for $200. During the next two years, the asset declines in value to $100, and Shareholder 2 redeems his share for $50, which fund satisfies by selling the asset and distributing $50 to Shareholder 2. At end of year 2, the fund will have a $100 capital loss carryover, and Shareholder 2 will have a $50 LTCL. Assume the fund reinvests the $50, which increases in value to $150, at which time the fund sells the asset, offsetting the $100 gain with the capital loss carryover.

In this example, the $50 tax loss recognized by Shareholder 2 when he redeemed stayed in the fund, and when the new asset increased in value, the fund was able to use the $50 to offset the subsequent gain. In essence, Shareholder 1 is getting the temporary benefit of Shareholder 2's loss: Shareholder 1 invested $100, his funds shares are worth $150, with no further gain or loss in the fund assets, and he has not paid any income tax. When he sells his share for $150, he will recognize the $50 of gain corresponding to his economic gain.

E. Summary

Certain aspects of Subchapter M can create potential tax externalities for both taxable and tax-exempt shareholders. When tax-exempt shareholders predominate, fund managers focus less on reducing ICTI and NCGs and thereby generate greater tax burdens and smaller accumulations for taxable shareholders. When fund managers focus on managing ICTI, NCGs, and fund overhang, taxable shareholders may benefit, provided the tax savings exceed the tax-motivated trading costs, but tax-exempt shareholders bear their share of these costs with little or no corresponding economic benefit. Finally, Subchapter M can result in the temporary acceleration of gains to non-redeeming shareholders and the temporary duplication of losses.

V. MODIFYING THE RIC TAX REGIME TO MITIGATE TAX EXTERNALITIES

This Part discusses possible legislative and regulatory actions that may help to mitigate some of the tax externalities discussed above.

Tax-exempt assets can be expected to constitute an increasing percentage of mutual fund assets, and the conflicts between taxable and tax-exempt investors will increase.

Other commentators, focusing solely on taxable U.S. investors, have proffered suggestions to amend Subchapter M to diminish some of the tax externalities discussed above. A common suggestion is for Congress to exempt capital gains realized by RICs from taxation, or alternatively, exempt reinvested capital gains from shareholder-level taxation.[241] If these proposals were enacted, a RIC shareholder would generally be taxed currently on a RIC's non-NCG dividends and be subject to capital gains only when he sold his shares. Thus, a RIC shareholder would only pay capital gains tax on gains economically accruing after he entered a fund, thereby eliminating the possibility of double temporary taxation of the same economic gains. Also, the importance of fund overhang would be significantly diminished.

Although these changes would eliminate many of the tax externalities discussed above and the conflicts between taxable and tax-exempt shareholders, they, in turn, would also raise several issues. For instance, exempting from tax the capital gains of RICs would result in a significant revenue loss: for 2012, mutual funds paid capital gains dividends of almost $100 billion.[242] At a time of weighty budget deficits, it may not be prudent to consider such changes. In addition, mutual fund investors would often be treated more favorably than if they directly owned the underlying assets: mutual fund investors would benefit from tax-free portfolio adjustments by the fund manager until they disposed of their fund shares.[243] Although some members of Congress have supported these proposals, they have not made much legislative progress.[244] Notably, although Congress made significant changes to Subchapter M in the RIC Modernization Act of 2010,[245] these proposals were not included.

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241. *See* Coates, *supra* note 223, at 614–17; Travis, *supra* note 223, at 848–57.

242. Equity funds paid capital gains of $66 billion, hybrid funds paid $5 billion, and bond funds paid $28 billion. INV. CO. INST., *supra* note 1, at 173 tbl.32. Although these gains would eventually be taxed when taxable shareholders sold their shares, the present value of the taxes to the government could be significantly reduced.

243. To the extent that mutual funds are owned largely by affluent taxable investors (outside of tax-exempt investments), these proposals would raise distribution concern. Also, in some instances, a mutual fund investor could be treated worse than if he held the shares directly. For instance, a mutual fund investor would not benefit by losses realized by the fund until he sold his shares. If he held the underlying shares directly, he could selectively realize losses to offset other realized gains in his portfolio.

244. *See, e.g.*, Generate Retirement Ownership Through Long-Term Holding Act of 2007, S. 2126, 110th Cong. (2007) (eliminating shareholder tax on reinvested capital gains dividends).

245. Regulated Investment Company Modernization Act of 2010, Pub. L. No. 111-325, 124

Another possible option would be to require mutual fund shareholders to mark-to-market their shares at year-end (or funds to mark-to-market their fund assets) and tax the shareholders on any gains or losses. Because shareholders of open-end funds are entitled to redeem at NAV, mutual funds must mark-to-market their assets on a daily basis. In a mark-to-market regime, fund shareholders may have their tax obligations accelerated compared to if they directly held the underlying fund assets. Consequently, Congress could provide for a special rate for mutual fund gains similar to section 1256.[246]

Although mark-to-market taxation has garnered many adherents, it is probably inappropriate to extend it to mutual funds without extending it generally to the assets held by mutual funds. Otherwise, compared to holding the underlying assets, fund investors would, in some cases, be penalized while reaping a tax windfall in other cases. Thus, if the tax rate on mutual fund gains were set too high, assets would flow out of mutual funds, and if the rate were set too low, mutual funds would in essence become tax shelters.[247]

In the absence of eliminating taxes on the capital gains realized by mutual funds or adopting other changes, such as mark-to-market taxation, Congress (or the SEC) should consider the following four options that specifically address and mitigate the conflicts arising from co-investment by taxable and tax-exempt shareholders: (1) require disclosure of the percentage of tax-exempt assets in a mutual fund; (2) adopt measures from Subchapter K to eliminate the temporary double taxation of gains (and double benefits from losses); (3) prohibit the co-investment of taxable and tax-exempt shareholders in mutual funds; and (4) create a new type of investment entity solely for tax-exempt investors.

A. Disclosure of the Percentage of Tax-Exempt Assets

One of the easiest and perhaps least expensive changes that should be considered is to require funds to disclose either quarterly or annually the percentage of assets held by tax-exempt investors.[248] Taxable investors

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Stat. 3537.

246. Under section 1256(a)(3), which requires holder of regulated futures contract to mark-to-market their contracts held at year-end, 40% of any gains or losses are short-term and 60% are long-term. *See* I.R.C. § 1256(a)(3) (2012). This results in a maximum rate of 28%. *See id.*

247. If a mark-to-market shareholder-level tax were enacted, there would also probably have to be some mechanism to provide cash with which fund investors could satisfy their tax liabilities. If the tax were at the fund level, the current distribution mechanisms would probably be sufficient.

248. A mutual fund will know which investors are tax-exempt in the case of direct investments in the fund, such as an investor opening an IRA account with a particular mutual

(or their advisors) would certainly benefit by knowing whether a particular fund has a significant percentage of assets held by tax-exempt investors, since such managers will certainly be less concerned managing a fund's ICTI, NCGs, and fund overhang. Likewise, tax-exempt investors holding a significant portion of assets in a fund will know that a manager may focus on managing the fund's ICTI and NCGs and therefore may have an incentive to engage in tax driven trades that provide no economic benefits for tax-exempt shareholders. This information could also be relevant for tax-exempt fiduciaries when choosing which funds to offer to tax-exempt investors. Required disclosure of this information is also consistent with the requirement to disclose after-tax returns.[249]

One possible consequence of requiring such disclosure is that taxable and tax-exempt investors may self-segregate so that funds will be held predominately by either taxable or tax-exempt investors. Such a result could be beneficial in that it would better align the interests of managers and their investors: tax-exempt managers would be concerned with maximizing pre-tax returns, and taxable advisors would be focused on maximizing after-tax returns.

If disclosure would result in taxable and tax-exempt investors self-segregating, certain benefits now implicitly provided by tax-exempt investors may be diminished. If a fund has a significant percentage of tax-exempt investors that regularly add to their holdings, for example, through payroll deductions, the periodic liquidity provided by the investors may permit the fund to hold a smaller percentage of liquid, lower yielding assets with which to satisfy possible redemption requests. Consequently, more of a fund's assets may be invested in potentially higher yielding assets.

The presence of tax-exempt investors may also help to mitigate the lock-in effect for taxable investors. For example, assume that a fund's assets have significantly appreciated and the fund shareholders own

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fund (or fund family). In addition, a fund that receives investments from third-party administrators of a company's deferred compensation plan, such as a 401(k) plan, will know that the investments are made on behalf of tax-exempt investors. In other situations, however, a mutual fund will not know whether the assets are tax-exempt assets. For example, if an investor opens an IRA at a brokerage house that, in turn, invests in a fund, the fund will only see an investment from the brokerage house. In addition, because ETFs are publicly traded securities and are most likely held in the name of the broker, it would be difficult for a fund to know whether the owner is tax-exempt or not.

249. The current required disclosure of after-tax returns is probably an insufficient proxy for these purposes, as past tax burdens may not reflect future tax burdens, especially when the percentage of tax-exempt investors changes. One instance in which this could occur is if a fund becomes (or ceases to be) an option for tax-exempt plans.

significantly appreciated fund stock. Even if the (taxable) shareholders believe the management may not be as successful in the future and they would be better off reallocating their assets, a sale of their stock would generate gains and taxes, and any new investment would have to be made with after-tax proceeds. It would only make sense to reallocate assets if the returns on the smaller after-tax investment base are high enough to make up for the missing returns on the taxes paid. Tax-exempt investors face no such constraints and may thus be a useful catalyst in helping to reallocate assets from poor performing managers, although their exodus could trigger taxable gains for non-redeeming taxable shareholders.

Finally, if disclosure causes an exodus of assets from certain funds, the remaining shareholders of those funds may see an increase in fund fees, as the fund expenses may have to be spread over fewer assets. Funds with low DC ratios generally have higher fees.[250] This could be beneficial to taxable investors to the extent that it provides an impetus for low DC ratio funds to lower their expense ratios.

B. Importing Principles from Subchapter K

For RIC shareholders, the current RIC regime can result in the uneconomic acceleration of taxable income because the gain realized by a fund shareholder upon a sale of his shares does not affect the inside basis of the fund assets. Thus, a fund shareholder who sells his shares will recognize a taxable gain if the fund's NAV has increased since he owned his shares. Since the gain recognized by a selling shareholder does not affect the inside basis of the fund's assets, when the fund sells assets and recognizes and distributes any gain, the *current* fund shareholders are taxed on the realized gains even though those gains may have accrued long before they became shareholders. When those gains are distributed, the fund's NAV drops and the shareholders who recognized the gains will have a smaller gain (or larger loss) when they eventually dispose of their shares. Thus, the shareholders who are taxed on this phantom gain should eventually recover this tax when they sell their shares.[251]

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250. Sialm & Starks, *supra* note 14, at 1418 tbl.VII (revealing that low DC ratio funds have an average monthly expense ratio of 0.106% and high DC ratio funds have an average expense ratio of 0.085%, a 20% difference).

251. Because the tax savings occur after the tax payments, the shareholder suffers economically because the present value of the tax payments is less than the present value of earlier taxes paid. Moreover, if the shareholder is taxed not only on NCGs but other STCGs and nonqualified dividend income, any loss recognized when the shares are sold will be capital (and can generally only offset capital gains plus $3000 for individuals), and the tax savings may therefore be absolutely less than the taxable income.

Similarly, a fund shareholder who sells his shares will recognize a loss if the fund's NAV has decreased since he owned his shares. Although the losses cannot be passed through to current shareholders, when the fund sells assets and actually recognizes the losses, the fund can use the losses to offset current and future fund gains. Thus, both the selling and current shareholders can benefit from the same losses. When the current shareholders sell their shares, if the losses have been used to offset taxable gains that have increased NAV, the shareholders will pay tax on those gains at that time.

Subchapter K has long contained provisions that mitigate the temporary taxation of the same economic gain or loss to different partners either when a partnership interest is liquidated or when a partnership recognizes gains or losses that accrued prior to entrance of a new partner. As seen below in some simple examples, adopting Subchapter K principles would possibly mitigate some of the uneconomic acceleration of taxation of RIC shareholders discussed above and the associated tax externalities. Applying these principles to funds, however, would almost certainly require Subchapter M to be repealed and would subject funds to possibly overwhelming administrative burdens, thus making the cure much worse than the disease.

As previously discussed in Part IV.D,[252] uneconomic taxation of fund shareholders can arise in the following circumstances: (1) a fund shareholder can be taxed on gain (or benefit from losses) that accrued before the shareholder purchased shares of the fund; and (2) the gain (loss) realized by a shareholder upon leaving a fund can be taxed to (used by) other shareholders when the fund actually realizes the gain (loss).

In order to prevent a taxpayer from using a partnership to shift gains and losses to another taxpayer on contributed appreciated or depreciated property, section 704(c) provides that built-in gains (and losses) on property contributed to a partnership can generally only be allocated to the contributing partner. Regulations under section 704(c) implement this goal by permitting a partnership to book-up (book-down) the book value of assets upon, inter alia, the entrance of a new partner to a partnership.[253] The change in the book value of the partnership assets does not affect the tax basis of the assets, but creates a difference

252. *See supra* Part IV.D.

253. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f) (2013) (describing revaluation of capital accounts upon capital contribution by new or existing partner); *see id.* § 1.704-1(b)(4)(i) (explaining tax items attributable to revaluations must be shared under section 704(c) principles).

between the book and tax values of the assets and is also reflected in the partners' capital accounts. When the assets are sold, the portion of the tax gain equal to the book-tax difference must generally be allocated to the *original partners* whose capital accounts were adjusted and cannot be shared with the new partner, regardless of how gains and losses are otherwise to be shared pursuant to the partnership agreement.[254] The allocation of these gains and losses are referred to as reverse 704(c) allocations. The result can be conceptualized as if the original partners had contributed their share of partnership property and the new partner contributed his property to a new partnership. In such case, section 704(c) would mandate that any built-in gain or loss in the property contributed by the original partners would have to be allocated to them.

If reverse 704(c) principles were applied to RICs, the problem of taxing built-in gain (or loss) inherent in a fund's assets to new shareholders could be mitigated.

> **Example 7: Allocating BIG under Reverse 704(c) Principles**
> Fund has one shareholder owning one share with a basis of \$100, an NAV of \$200, and a built-in NCG of \$100. New shareholder purchases an additional share from the fund for \$200—the fund's NAV will remain at \$200 (\$400 divided by two shares). If reverse 704(c) principles are applied to the fund, when the fund sells the asset with the built-in NCG, the first \$100 of NCG would be taxed to the original shareholder.

Reverse 704(c) principles cannot easily be incorporated into the current Subchapter M regime because of the different ways that partnerships and corporations treat distributions. Under Subchapter K, the entire \$100 would be allocated and taxed to the original shareholder, and he would increase his basis by \$100.[255] Both the original and new shareholder would then have a basis of \$200, which would match the fund's NAV. Under general corporate tax law principles, dividends are generally distributed pro rata, and a shareholder is generally not taxed on corporate earnings until they are distributed. If the \$100 were distributed pro rata as required under current law, both the new and original shareholder would each receive \$50, and the NAV of the fund would drop to \$150 ((\$400 - \$100)/2). Because a dividend distribution does not affect a shareholder's basis in his shares, the original and

254. *Id.* § 1.704-3(a)(6)(i) (explaining when principles of section 704(c) apply in the case of book-tax differences arising upon a revaluation).

255. I.R.C. § 705(a)(1)(A) (2012).

current shareholders would have a basis in their fund shares of $100 and $200, respectively. The original shareholder would have built-in gain of $50, and the current shareholder would have a built-in loss of $50. Even though the economically correct result is to tax the original shareholder on $100 that accrued while he was the sole shareholder, if the fund income is distributed pro rata, he is taxed only on $50 and the new shareholder on $50.

There are some possible solutions, but none of them are administratively easy to implement, and they would require a repeal of many of the basic concepts of Subchapter M. In this simple example, one possible solution would be to require fund distributions to follow allocations of a fund's taxable income so that the original shareholder would receive $100 and the new shareholder $0. In addition, upon the distribution of the $100 to the original shareholder, it would be necessary to reduce the original shareholder's interest to half of a share. There would then be 1.5 shares outstanding, resulting in a NAV of $200 ($300/1.5). Neither the new shareholder nor the original shareholder would have any unrealized gain or loss, because the value of their shares, $200 and $100, respectively, would equal their basis.

More importantly, the record-keeping burdens would probably be extraordinary. Each time a new shareholder entered a fund, the fund would have to keep track of each current shareholder's share of the fund's built-in gain or loss in each asset. Given the number of assets, the fact that identical assets with different bases (for example, shares of Apple purchased at different prices) are distinct tax assets, and the large number of shareholders of a typical fund, it would probably be impossible to comply with the required book keeping.[256]

Even if a reverse 704(c) system were implemented for RICs, it would not by itself be sufficient to prevent the uneconomic allocation of a fund's gain (or loss) to new shareholders when a departing shareholder

256. Under current law, reverse 704(c) allocations must generally be made on a property-by-property basis. Treas. Reg. § 1.704-3(a)(2). To reduce the recordkeeping burden of property-by-property accounting, the regulations permit securities partnerships to aggregate gains and losses from qualified financial assets. *Id.* § 1.704-3(e)(3)(i). Some commentators have argued for expanding the class of partnerships eligible to use aggregation. *See, e.g.*, N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON AGGREGATION ISSUES FACING SECURITIES PARTNERSHIPS UNDER SUBCHAPTER K 12–14 (2010), *available at* http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1220Rpt.pdf (discussing application of aggregation provisions to tiered partnerships). *But see* Letter from Terence Cuff, Partner, Loeb & Loeb LLP, to Michael Mundaca, Assistant Sec'y, Tax Policy (Mar. 30, 2011) (available in LEXIS, Fedtax Library, TNT File, 2011 TNT 66-24) (arguing that aggregation should be eliminated for securities partnership and suggesting that the administrative burden of complying with property-by-property accounting may not be overwhelming given modern computer software).

recognizes gain (loss), while the partnership holds property with built-in gain (built-in loss).

<u>Example 8: Double Taxation of the Same Economic Gain</u>

Fund has one shareholder owning one share with a basis of \$100, an NAV of \$200, and a built-in NCG of \$100. New shareholder purchases an additional share for \$200. The fund's NAV will remain at \$200 (\$400 divided by two shares). Original shareholder redeems from the fund for \$200, which satisfies the redemption with the cash contributed by new shareholder.

In this scenario, the original shareholder will have a gain of \$100 (\$200 received less basis of \$100), but at the fund level, there is no taxable gain to allocate to the original shareholder because the fund has not sold the appreciated asset. If the built-in gain is realized in a subsequent year, it will be allocated to a new shareholder. The same \$100 gain will be taxed to the original and new shareholder, and when the \$100 is distributed to the new shareholder, he will still have a basis of \$200 in his fund share, and the fund's NAV will be \$100, resulting in a built-in loss of \$100.[257] This pairing of present taxation and a built-in loss makes the taxation temporary.

The same temporary double taxation arises when a partnership distributes cash in an amount exceeding a partner's basis in his partnership interest and the partner recognizes gain.[258] Since the basis of partnership assets are generally not adjusted when property is distributed,[259] when any built-in gain is subsequently recognized, it will be allocated and taxed to the remaining partners. Thus, the same gain is temporarily taxed twice.

To alleviate this temporary double taxation, a partnership can elect to adjust the basis of its assets by the gain recognized by the departing partner.[260] Consequently, when the partnership sells the appreciated

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257. An analogous result occurs when the fund has built-in loss property and the selling shareholder recognizes a loss. When the fund recognizes the loss, the new shareholder will temporarily get the benefit of the loss as it can be used to reduce fund income.

258. I.R.C. § 731(a)(1). In the case where a partner recognizes a loss upon the liquidation of his partnership interest, the partnership may be required to reduce the basis of its property by the amount of the loss even if a section 754 election is not made in order to prevent the departing and current partners from both using the loss. *Id.* § 734(d). A partner recognizes loss when the amount of the cash received in complete liquidation of the partnership interest is less than the basis in the partnership interest. *Id.* § 731(a)(2).

259. *Id.* § 734(a).

260. The election is made pursuant to section 754; consequently, the partnership must adjust

property, the gain that was taxed to the departing partner will not be taxed again. In this simple example, the entire basis adjustment would be allocated to the sole property held by the partnership. But where the partnership holds multiple properties, the basis adjustment is allocated among the property pursuant to detailed regulations.[261]

Again, the administrative burdens that would arise if section 754 and section 734 principles were imported to mutual funds would be overwhelming. Each time a shareholder redeemed his shares, the fund would have to adjust the basis of all of the fund property to prevent double taxation of the same gain (or double use of the same loss). It is the author's understanding that most private equity and hedge funds that generally have significantly fewer shareholders and do not offer daily redemption rights do not make a section 754 election because of the associated administrative burdens.[262]

Finally, in the case where a shareholder sells his shares to a third-party, for example, in the case of a shareholder of a closed-end fund, and recognizes gain, neither 704(c) nor 734(b) would be sufficient to prevent temporary double taxation.

Example 9: Double Taxation of the Same Gain When Shares Sold

Closed-end fund has one shareholder owning one share with a basis of $100, an NAV of $200, and a built-in NCG of $100. Original shareholder sells his share to new shareholder for $200. The fund's NAV remains at $200. When the fund subsequently sells the appreciated property for $200, the fund will recognize gain of $100, which will be taxed to new shareholder when the fund distributes the gain. New shareholder will still have a basis of $200 in the fund, but the fund's NAV will be $100. Thus, both original and new shareholders are taxed temporarily on the same $100 gain, but when the new shareholder sells his share, the loss may possibly offset the gain.

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the basis of its property pursuant to section 734(b). *Id.* §§ 734(b), 754.

261. Treas. Reg. § 1.755-1 sets out the rules for adjustments under section 734. In the case of an adjustment arising from gain recognized upon the distribution of cash, the section 734 adjustment is allocated only to capital gain property and then among capital gain property with unrealized gain in proportion to the unrealized appreciation, but only to the extent of unrealized appreciation. Any remaining increase is allocated among the same properties in proportion to their fair market value. Treas. Reg. § 1.755-1(c)(2).

262. *See* David S. Miller & Jean Bertrand, *Federal Income Tax Treatment of Hedge Funds*, 65 TAX LAW. 309, 333 (2012) (explaining that because of administrative difficulty in making basis adjustments, most hedge funds do not make a section 754 election).

When a partner sells his partnership interest to a third-party, the partnership generally does not adjust the basis of its property.[263] To mitigate the double taxation of gain that can arise when a partner recognizes gain and no adjustment is made to partnership property, a partnership can make the section 754 election to adjust the basis of its property by the gain recognized by the selling partner under section 743(b).[264] In contrast to the section 734(b) adjustment, the section 743(b) adjustment applies *only* to the purchasing partner. When the partnership sells property for which there is a (positive) section 743(b) adjustment in effect, the partner's share of the gain or loss relating to the property is reduced by the section 743(b) adjustment.

In the above example, if the fund were a partnership with a section 754 election in effect, when the fund sold the property, the new shareholder's share of the gain ($100) would be reduced by $100 to $0. Since the partner would not be taxed on the gain, his basis would remain at $200 until the proceeds were distributed, which would decrease his basis by $100, resulting in a final basis of $100 and an NAV of $100. In essence, to the extent that a new partner pays for his share of any built-gain, when the gain is recognized, the partner is not taxed on it.

Here too, applying Subchapter K principles to mutual funds would be administratively burdensome. For each new shareholder, the fund would have to determine the shareholder's share of his built-in gain (loss) in each asset so that he would not be taxed on the gain (loss) when the asset is sold. In addition, these adjustments could not readily be done in the confines of Subchapter M.

These simple examples have illustrated some of the mechanisms in Subchapter K that aim to ameliorate the temporary double taxation (benefits) of the same gains (losses) to more than one partner or the shifting of built-in gains and losses to new partners. Because of the extreme computational and administrative burdens these provisions impose, even partnerships with a small number of partners do not lightly make a section 754 election. Given the large number of assets and shareholders of a typical mutual fund and the large number of daily

263. I.R.C. § 743(a).

264. *Id.* §§ 743(a)–(b). Technically the amount of the adjustment is the difference between the new partner's outside basis and his share of the inside basis of the partnership property. The rules for determining a partner's share of the inside basis are found in Treas. Reg. § 1.743-1(d). The section 743(b) adjustment is allocated among properties under the rules Treas. Reg. §§ 1.755-1(b)(1)–(2). Roughly, the adjustment is allocated among the partnership properties based on the gain or loss the purchaser would receive if the property were sold for its fair market value. *Id.*

redemptions and purchases, the administrative burdens that the section 704(c) and 734—as well as section 743—adjustments require would be overwhelming. Additionally, it is probably impossible to implement these changes within the current Subchapter M regime. Subchapter M is largely a corporate tax regime: income earned by a fund is not taxed until it is distributed and losses do not affect a shareholder's basis, distributions of earnings must generally be made pro rata, and distributions of earnings do not affect a shareholder's basis.[265] Therefore, Subchapter M would not be a hospitable environment for a transplant of Subchapter K principles.

C. Separating Taxable and Tax-Exempt Investors

The partial pass-through regime of Subchapter M creates irreconcilable conflicts for managers that lead to tax externalities. To mitigate these conflicts and their costs for shareholders, serious consideration should be given to limiting co-investment by U.S. taxable and tax-exempt investors in the same fund.[266] Separating investors by their tax status would certainly better align the tax interests of shareholders and managers: managers of taxable funds would be incentivized to maximize after-tax returns, and managers of tax-exempt funds would be incentivized to maximize economic returns. Segregating taxable and tax-exempt investors could be accomplished by either explicitly prohibiting co-investment by taxable and tax-exempt

265. Publicly traded partnerships ("PTPs"), which are taxed as partnerships but whose interests are publicly traded, face some of the issues discussed above. For example, for a partnership that has a section 754 election in effect, the transfer of a PTP interest requires the PTP to maintain a separate basis adjustment for the benefit of the transferee partner. For a detailed discussion, see Deborah Fields, Holly Belanger & Eric Lee, *Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part IV—Secondary Offerings and the Impact of Public Trading*), TAXES, Oct. 2010, at 25, *available at* http://www.naptp.org/documentlinks/Investor_Relations/KPMG_PTP_Primer_Part_IV.pdf (describing the complex and unique federal income tax issues associated with natural resources PTPs); *see id.* at 33 (explaining how to calculate the special basis adjustment). Because the issuance of additional equity is a rare event for a PTP, a PTP does not face the same magnitude of reverse section 704(c) allocations as would a RIC.

266. It could be argued that separating nominally taxable and tax-exempt investors is somewhat arbitrary. A U.S. taxable person could be temporarily tax-exempt, for example, if the person had significant non-fund losses. In addition, some fund investors may be taxable, but subject to tax at a relatively low rate. A fund composed of taxable investors subject to a wide range of tax rates also raises, to some extent, issues similar to those addressed in this Article. For example, if most of the shareholders were subject to marginal tax rates of 39% on income and 20% on capital gains, a manager may make different tax-motivated trading decisions than if most of the shareholders were subject to marginal tax rates of 15% and 5%. It is probably not desirable or administratively feasible to make distinctions at the fund level between U.S. taxable investors based on (possibly temporary) differences in marginal tax rates.

investors, or by providing for a new type of optional alternative investment vehicle for tax-exempt investors.

If taxable and tax-exempt investors were prohibited from co-investing in the same fund, any fund with both types of shareholders would have to split up the assets of the fund. This could be accomplished in various ways. One simple way would be for a fund to distribute in-kind its assets to either taxable shareholders or tax-exempt shareholders, who could then contribute the distributed securities to a new fund. Because of the liberal rule of section 852(b)(6), which permits the tax-free distribution of securities by a RIC, the split up could be accomplished without generating tax burdens for either the remaining or departing shareholders.[267]

The split-up of a fund could possibly be operationally disruptive. After the split-up of a fund's assets between taxable and tax-exempt shareholders, both the parent and offspring fund would have a smaller asset base than the original fund, and it is possible that management fees could increase for both funds. Given the size of taxable and tax-exempt investments, however, most offspring and parent funds would have sufficient assets so that management costs should not increase significantly. If, however, either the parent or offspring fund were small, it could be necessary to liquidate the fund or merge it into another fund. In addition, if the original fund were actively managed, since the parent and offspring fund would each probably need a separate manager, one group of shareholders would be deprived of the possibly alpha-enhancing skills of the manager of the original fund. Consequently, if a split-up would generate significant direct and indirect costs, consideration could also be given to continuing to permit co-investment by taxable and tax-exempt investors in the same fund, provided that the fund disclose the percentage of tax-exempt assets.

D. The Retirement Mutual Fund

Another potentially more interesting option would be to authorize the creation of a new type of mutual fund, the Retirement Mutual Fund, available solely to U.S. tax-exempt investors, such as IRAs, Roth IRAs, 401(k)s, and 403(b) accounts.[268] Since the only shareholders of the

267. If legislators ultimately choose this option, Congress could provide for legislation that would facilitate the tax-free separation of tax assets and shareholders. When section 851(g), which provides for the separate tax treatment of series funds, was enacted in 1986, Congress specifically provided a remedial rule that permitted an existing corporation with more than one fund to reorganize on a tax-free basis to separate entities. *See* Tax Reform Act of 1986, Pub. L. 99-514, § 654(b)(2), 100 Stat. 2085, 2298.

268. Although foreign investors do not pay U.S. tax on a fund's NCGs, interest related

Retirement Mutual Fund would be U.S. tax-exempt investors, the managers of the Retirement Mutual Fund could focus solely on maximizing the economic return of the fund (and its shareholders) and would no longer need to be concerned with minimizing ICTI, reducing fund overhang, etc.

Because the Retirement Mutual Fund would be open only to U.S. tax-exempt investors, many of the current provisions of Subchapter M that were enacted prior to the creation of U.S. deferred compensation provisions and that are relevant only for taxable investors could be abolished. In particular, because all of the shareholders of the Retirement Mutual Fund would be tax-exempt, there would be no need to distribute the fund's earnings so that the shareholders have sufficient cash with which to satisfy their tax liabilities.[269] Consequently, the distribution requirements of section 852(a)(1) applicable to ICTI and tax-exempt interest income and the tax on a fund's retained NCGs in section 852(b)(3)(A) could be repealed. Also, the special rules regarding the determination of the E&Ps of a fund of section 852(c) and application of the section 4982 excise tax also could all be eliminated for the Retirement Mutual Fund. Abolishing these requirements would not only save the direct costs of distributions, share issuances upon reinvestments, etc., but should eliminate tax-related burdens and compliance costs. Funds no longer would need to determine NCGs, ICTI, and E&Ps, and shareholders (and fund administrators) would no longer have to keep track of the adjusted basis of a their fund shares.[270] These savings would directly increase shareholder returns.

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dividend, or STCG related dividend, as defined in sections 871(k) and 882(m), they would not be considered to be tax-exempt persons because they still pay U.S. tax on dividends and foreign source interest received by a fund. Consequently, a fund must still determine the tax character of its income in order to determine the tax liability, if any, of its foreign investors.

269. This justification for the distribution requirement is questionable even for taxable investors as the overwhelming majority of investors reinvest all dividends. *See* Arden Dale, *Rethinking Reinvestment: Tax Hassles Lead Some Investors to Think about Taking Dividends in Cash*, WALL ST. J., May 7, 2012, http://online.wsj.com/article/SB1000142405 2702304432704577348090646918980.html (explaining that 91% of stock fund dividends and 81% of bond fund dividends reinvested); Woodrow T. Johnson & James M. Poterba, *Taxes and Mutual Fund Inflows Around Distribution Dates* 7 (Nat'l Bureau of Econ. Research, Working Paper No. 13884, 2008), *available at* http://www.nber.org/papers/w13884.pdf (providing that in the sample studied, 97.1% of accounts and 95.9% of dollar-weighted accounts reinvest dividends).

270. A very significant burden for taxable individuals is to track the basis of fund shares. Each time an investor reinvests fund dividends, the acquired shares will generally have a different basis than the original purchases because the NAV of the fund has changed. A taxpayer may elect among various methods to determine the basis of the shares sold, such as average cost, specific identification, or first in, first out ("FIFO"). *See* Treas. Reg. § 1.1012-1(c) (2013) (explaining specific identification and FIFO); *id.* § 1.1012-1(e) (explaining average cost). Since

It should be noted that Retirement Mutual Funds, like regular RICs, would still be subject to the same securities regulations and non-tax provisions of Subchapter M, such as the diversification requirements—but they would no longer be burdened with superfluous tax-related requirements. If the Retirement Mutual Funds were created, there is no reason why these funds could not also coexist with current RICs. Tax-exempt shareholders who wanted to invest with a particular manager in a regular RIC or ETF would still have the option. Taxable shareholders, who are clearly harmed by the presence of tax-exempt shareholders, should welcome the creation of the Retirement Mutual Fund because it should foster the movement of tax-exempt investors out of regular RICs. Finally, the creation of the Retirement Mutual Fund should foster competition between regular RICs and Retirement Mutual Funds. Based on the returns of the respective types of funds, investors could evaluate and choose the best alternative. If it turns out that the returns of Retirement Mutual Funds exceed those of regular RICs, the experiment would be useful for both taxable and tax-exempt investors.

CONCLUSION

This Article has discussed various problems arising when taxable and tax-exempt shareholders invest together in mutual funds. The partial-pass-through regime of Subchapter M was originally designed to be a relatively simple regime for taxable investors. When all investors are taxable investors, a manager's mandate is clear: maximize after-tax returns. This requires that a manager focus on controlling fund income and gain. In addition, because of the uneconomic allocation of mutual fund gains to new shareholders, fund managers also focus on fund overhang.

With the enactment of the IRA and 401(k) regimes, the percentage of mutual fund assets held by tax-exempt investors has exploded over the last forty years and will only continue to increase. As tax-exempt investors come to hold a significant portion of mutual fund assets, fund managers appear to be less concerned with managing current fund income and gains. Consequently, the after-tax returns of taxable investors in funds where tax-exempt investors predominate may be reduced.

Importing principles from Subchapter K could address many of the deficiencies of Subchapter M that lead to temporary over and under

2012, brokers have been required to report to the IRS the gross proceeds of the sale of a mutual fund and the cost basis of the shares sold. I.R.C. § 6045(g) (2012). A taxpayer must use the method selected by the broker unless he opts out. *Id.* § 6045(g)(2)(B)(i)(II).

taxation of new shareholders, but as demonstrated above, adopting Subchapter K principles would not be administratively feasible. Furthermore, even if such principles were adopted, the conflict between taxable and tax-exempt investors would still remain. Disclosure of the percentage of tax-exempt assets in a fund would aid taxable and tax-exempt investors to find funds with the same tax clienteles, but it is an incomplete solution, especially for funds in which tax-exempt investors predominate, as these funds are still burdened with the unnecessary tax costs of Subchapter M.

The Retirement Mutual Fund is clearly the best choice among these options. Since it would only be available for tax-exempt investors, the Retirement Mutual Fund would eliminate entirely the conflict between taxable and tax-exempt investors. Fund managers for taxable funds could focus on maximizing after-tax income, and fund managers for the Retirement Mutual Funds could focus on maximizing pre-tax returns. Furthermore, the elimination of unnecessary tax distribution, reporting, and record-keeping requirements would reduce fund costs and increase shareholder returns, a win for all investors.