Recent Decisions: Internal Revenue--Gift Taxation--Valuation of Mutual Fund Shares \([Howell v. United States, 290 F. Supp. 690 (N.D. Ind. 1968)]\)

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statutorily exempt category, the Court may well have provided an efficient and fool-proof method of preserving individual rights on the one hand and preserving the Selective Service System as a viable administrative agency on the other.

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INTERNAL REVENUE — GIFT TAXATION — VALUATION OF MUTUAL FUND SHARES


Shares in open-end investment companies,1 popularly called mutual funds, have long been listed in the daily security quotations at two distinct prices — the bid price and the asked price.2 Yet for years there has been much controversy concerning the proper method of employing these representative figures in order to arrive at a per share valuation which would satisfy the Commissioner of Internal Revenue. Prior to 1963, the Treasury regulations for gift taxation did not specify which of the mutual fund prices, if either, was to be used as the value upon which the gift tax would be assessed. Consequently, the taxpayer often used either the lower bid price or the mean between the bid and asked prices, the latter method being consistent with the method used to value other securities.3 However, in 1963, the Treasury Department promulgated gift tax regulation

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1 Open-end investment companies are defined and regulated by the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 (1964) [hereinafter cited as Investment Act].

2 The net asset value of a mutual fund share, usually called the bid price or public redemption value, is computed twice daily by subtracting the liabilities of the fund from the market value of all investments owned by the fund and pro rating that value over the number of outstanding shares.

The asked price or public offering price is computed by adding to the bid price per share an additional charge known as the load or load charge which represents the issuing expenses and accordingly varies from approximately 2 percent to 8 percent depending upon the number of shares purchased at one time. See Investment Act, 15 U.S.C. § 80a-2(34) (1964).

It should be noted that the load charge is paid entirely to the underwriters, dealers, and brokers who distribute and sell mutual fund shares and does not revert to the fund or its management.

3 The regulations for the valuation of most types of securities provide that the fair market value per share or bond is the mean between the highest and lowest selling prices on the valuation date. Treas. Reg. § 25.2512-2(c) (1958). It is this fair market value that constitutes the basis upon which the gift (or estate) tax shall be imposed. For the estate tax regulation, see Treas. Reg. 20.2031-2(c) (1958).
25.2512-6(b), which provides that shares of mutual funds shall be valued at the higher public offering price (the asked price) at the date of the gift.⁴

The silent, but growing, disenchantment with this standard was recently manifested in the case of Howell v. United States,⁵ wherein the taxpayer directly challenged the validity of the regulation. This attack brought under judicial scrutiny, for one of the very few times in many years, all the problems which are inherent in the valuing of mutual fund shares. Ultimately, the court's opinion serves to emphasize the necessity for the Treasury Department to offer a more lucid explanation of the relevant considerations which underlie any newly published regulation.

In Howell, the taxpayer made an inter vivos gift of 45,085 open-end investment company shares which she valued at the public redemption price in calculating the amount of gift tax due on the transfer. Once she had paid the tax, the Commissioner, relying on Treasury regulation 25.2512-6(b), determined that the shares should have been valued at the public offering price, and assessed the deficiency. In her claim for a refund, after paying the deficiency, the taxpayer attacked the validity of the regulation with four major arguments: (1) The net asset value, the public redemption price, is realistically determined by the stock market; but the public offering price is set by the issuer and is artificial. (2) The value of stocks and bonds sold on the national exchanges has been set at the mean between the highest and lowest selling prices on the date of the gift. That value does not include brokers' commissions; but the public offering price value of the regulation does include such commissions, as reflected in the load charge which is added to the public redemption price. To distinguish between mutual funds and

⁴ Treas. Reg. § 25.2512-6(b) (1958), as amended, T.D. 6680, 1963-2 CUM. BULL. 417, provides that "[t]he fair market value of a share in an open-end investment company... is the public offering price of a share, adjusted for any reduction in price available to the public in acquiring the number of shares being valued."

⁵ 290 F. Supp. 690 (N.D. Ind. 1968).
stocks and bonds in this manner is, therefore, arbitrary. (3) The public offering price valuation discriminates unfairly against the taxpayer who makes a taxable gift of a relatively small number of mutual fund shares, since that load charge varies according to volume. (4) The regulation under attack fails to take into account the well-established rule that the taxable value of a gift, subject to a liability (herein the sales or load charge), may not exceed the fair market value of the gift less the fair market value of the liability.

Although the court admitted that these arguments were strong and imaginative, it felt compelled to uphold the regulation's method of valuation as reasonable. In order to arrive at this determination, however, the court found it necessary to draw upon a well-worn rationale: even though other reasonable methods of valuation may exist, the method prescribed in the regulation will not be struck down so long as it too, may be deemed reasonable.

To fully appreciate the import of the taxpayer's reference to the principles governing stock traded on the national exchange, it is necessary to examine the characteristics of an open-end investment company. As defined by statute, an open-end investment company is a company which offers for sale or has outstanding any redeem-

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6 Id. at 692. For a discussion of this latter rule in a more general context, see Commissioner v. Proctor, 142 F.2d 824 (4th Cir. 1944); Jackman v. Commissioner, 44 B.T.A. 704 (1941). The taxpayer in Howell, via this fourth argument, was requesting the court to treat the sales charge as within that category of liabilities which pass with — and thus detract in value from — the asset being transferred. See notes 27 & 28 infra & accompanying text.

7 Id. at 693, citing Mearkle's Estate v. Commissioner, 129 F.2d 386, 388 (3d Cir. 1942). In a similar case Estate of Wells, 50 T.C. No. 88 (Sept. 16, 1968), the Tax Court upheld the reasonableness of Treasury regulation 20.2031-8(b), (1958), as amended, T.D. 6680, 1963-2 CUM. BULL. 417, which provides for the valuation of open-end investment company shares for estate tax purposes by the same method as does gift tax regulation 25.2512-6(b). See note 4 supra.

The executor-taxpayer in Wells valued the decedent's mutual fund shares at the public redemption price. The district director, proceeding under the regulations, valued the shares at the higher public offering price and assessed a deficiency against the estate. In support of his position, the taxpayer argued that no meaningful distinction existed between a mutual fund share and any other security to warrant different methods of valuation. However, the court was persuaded by the Commissioner's argument that the only willing buyer-willing seller transactions which occurred were when the fund sold its own shares at the public offering price, and that the public offering price was, therefore, one reasonable alternative for the valuation of the shares. Citing Mearkle's Estate v. Commissioner, supra, in support of its position, the court held that where the method used is reasonable, that method must prevail despite the existence of other reasonable alternative methods.

A strong dissent in Wells criticized the majority for adopting the Commissioner's arguments. The dissenters maintained that since the public redemption price was all that could ever be realized from the sale of a mutual fund share, that price should be the strongest indicia of value.
able security of which it is the issuer. Typically, a mutual fund sells an unlimited number of shares in itself; the proceeds from such sales are then invested in other securities under the guidance of the management company which operates the fund. Shares in the fund are continually sold and redeemed through one or more of the following channels: (1) Salesmen employed by the management company sell the fund's shares directly to the investor. (2) By contract between the management company and an underwriter, who subsequently distributes the shares through a number of dealers and brokers. (3) By direct contracts between the management company and the dealers or brokers. Generally, each sale of a mutual fund share includes a load charge which is paid to the underwriters, brokers, and dealers in exchange for their services and thus, represents the costs of distribution.

Within the framework of the aforementioned channels of distribution, most mutual fund share transactions may be characterized as dealings between the fund and the investor. Few exchanges are conducted between private investors, since brokers are often restricted by their distributing contracts to non-private sales and therefore may not serve as the agent or conduit which is normally needed to consummate a private sale. In the absence of such con-

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8 Investment Act, 15 U.S.C. § 80a-5(a)(1) (1964). The Investment Act classifies this type investment company as a "management company." See 15 U.S.C. § 80a-5(a)(1)(1964). This statutory classification of management company should not be confused with the concept of a mutual fund manager, the independent company which manages the investments of the fund. The latter is many times called a management company. Management company as used in this Article will refer to the mutual fund manager. See note 9 infra.

Another source has defined the investment company as essentially a liquid aggregation of capital, consisting of public savings turned over for investment and productive enterprise, which normally invests for yield as distinguished from control of productive enterprise. Aldred Inv. Trust v. SEC, 151 F.2d 254 (1st Cir. 1945), cert denied, 326 U.S. 795 (1946). For a discussion of the complex legal relationships which exist within an open-end investment company, see Lobell, The Mutual Fund: A Structural Analysis, 47 VA. L. REV. 181 (1961); Lobell, Rights and Responsibilities in the Mutual Fund, 70 YALE L.J. 1258 (1961).

9 The managers are, in effect, the alter egos of the funds. Often the managers are men who have decided to establish a mutual fund, then sell their services to the fund for a fee — usually ½ percent the value of the fund assets. The management provides a variety of administrative services, ranging from portfolio advice to selection of sales personnel. For further discussion of this area, see Gopman, Current Problems in the Regulation of Mutual Fund Selling Practices, 24 BUS. LAW. 409 (1969).

10 See note 2 supra. Some funds, commonly known as "no load" funds, sell and redeem their shares at the net asset value per share and assess no load charges. These funds present no valuation problems under the regulation and are, therefore, beyond the scope of this article.

tractual constraints, however, private transactions are not prohibited by the Investment Company Act of 1940. Still, within the restricted market the fund remains the dominant seller and the reluctant redeemer. The individual investor is in a substantially weaker position, since he can purchase shares only if he buys on the fund’s terms and at its established price, and can sell only if he chooses to sell at the lower bid price by exercising his redemption rights. The absence of free negotiations over the terms of sale makes this market almost unilateral.

The principal question that confronted the court in the instant case was whether it should treat Mrs. Howell’s shares like securities sold on the national stock exchanges, or whether mutual fund shares should be valued differently. In holding that the public offering price was the proper measure of value, the court recognized the importance of the dissimilar characteristics of the markets in which the different securities are traded. Unfortunately, however, the court’s analysis did not probe these markets to ferret out the crucial distinctions which support the inclusion of distribution costs in the valuation of mutual fund shares alone.

In responding to the taxpayer’s first two arguments, the court raised two interrelated and market-oriented considerations — the concepts of fair market value and costs of distribution. First, the court noted that the general method of valuation to be used under both the estate and gift tax regulations must follow the Commissioner’s explication of fair market value: that ascertained from a transaction between a willing buyer and a willing seller, with neither being under any compulsion to buy or sell and both having full knowledge of all relevant facts. This characterization, of course, applies in the case of the larger national securities exchanges and

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13 It is interesting to note that the mutual funds come within a comprehensive regulatory scheme which covers most securities and provides controls on the right of redemption, the establishment of the public offering price, and the distribution practices. For a listing of the relevant statutory guidelines, see Investment Act, 15 U.S.C. §§ 80a-22(a)-(e) (1964). Generally, the Investment Company Act of 1940 grants to the National Association of Securities Dealers the power to regulate the practices of its members in accordance with statutory guidelines. For an excellent compilation of their enacted rules, see CCH NASD DEALERS MANUAL (1967).


over-the-counter markets, where transactions are the result of unrestricted negotiations between buyers and sellers.

But the characterization of the mutual fund market is different; and thus the Treasury Department contrived a new definition of fair market value — the public offering price — for estate and gift taxation of mutual fund shares. The Howell court then, in applying the one reasonable alternative rationale, justified the different valuation methods by merely observing that in mutual fund transactions there are no willing buyers and sellers. Since the fund sells at its net asset value plus the load charge and redeems only if the investor elects to exercise that right, there is absent in the mutual fund market the value-determining phenomena of free negotiations which prompted the fair market value standard of the Commissioner for regular securities.

In a superficial way, the reasoning of the court was correct. Without free negotiations, the general standard for fair market value should not apply; and the different standard of public offering price is one reasonable alternative. In order to respond completely to the taxpayer's first argument, however, the court should have answered the crucial question which it only raised and dismissed as unnecessary to decide: Is a mutual fund a mere agency (or conduit) for its shareholders, or is it a separate and distinct business entity? A brief analysis of mutual fund companies will reveal the best answer to this question and will further disclose the ultimate reasons for employing different standards of fair market value.

The mutual fund exists as a separate business entity — a traditional commercial operation. Contrary to Mrs. Howell's assertions, it cannot be deemed a mere conduit through which flow directly all profits from investment in the regular securities. If this

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17 See note 7 supra & accompanying text.
19 290 F. Supp. at 693. The court considered it unnecessary to answer the question in the text because the method of valuation in the regulation under attack could be deemed reasonable no matter how the mutual fund company was conceptualized. Id.
20 In a footnote, the court mentioned that in the Wells case the Tax Court rejected the taxpayer's "conduit" argument and determined that the mutual fund has full ownership in the investments while the shareholders merely own stock in the company. 290 F. Supp. at 693 n.15. The Howell court then went on to note that the Internal Revenue Code treats mutual funds as conduits for income tax purposes, but that there is no such treatment in the gift tax area. See INT. REV. CODE OF 1954 §§ 851-55. This, said the court, lent support to the government's position in the instant case. 290 F. Supp. at 693 n.15.
were the case and the mutual fund were treated as an agent or broker for mutual fund shareholders, then certainly the court would have had to have considered the general securities market as relevant for value determination and thus treated the net asset value of the mutual fund shares as the true fair market value. But the fund does more than siphon off profits or net asset value to its shareholders. The fund is a business entity, which, through its selection of a management company, has full control over the investments which it makes and incurs all the normal liabilities of a commercial operation. The mutual fund shareholders merely purchase stock in the inventory — investments — of the fund. There is no willing buyer-willing seller relationship because the company creates its own market, with unique characteristics.

Implicit in the creation of the new investment market is the one unique characteristic which the taxpayer attacked in both her first and her second arguments — the load charge. Mrs. Howell argued that the load charge should not be included in the valuation, or (in the alternative) as included it was arbitrarily set. In order for the court to respond properly to these first two arguments, therefore, it should have discussed the market distinctions which necessitate the imposition of that charge for valuation purposes.

As stated above, the first step in the court's discussion should have been the determination that a mutual fund is a separate business entity. The second step, upon which hinged the entire decision, should have been an analysis of the load charge itself. Again, however, the court failed to respond to the taxpayer's allegation. The court's second observation was merely that the inclusion of distribution costs in the value of mutual fund shares, but not in the value of other securities, should not be considered significant because many other items are marketed at a price which includes the expense of distribution and sale. Thus, the court attempted to

21 As discussed in note 2 supra, the net asset value of mutual fund shares is determined directly by reference to the market value of regular securities and other investments held by the investment company. If the market for regular securities were considered the sole-determining market for mutual fund shares, then the public redemption price (net asset value without the load charge added on) would have to be treated as the true fair market value and the distribution costs (load charge) would be viewed as similar to the brokerage fees.

22 In both Wells and Howell, the courts analogized the mutual fund shares to several types of assets, the most notable of which is the insurance policy. The Howell court stated that the load charge is merely an expense of marketing, similar to the insurance situation in which the replacement value cost is determined by including in the computation the commission paid to the insurance salesman. 290 F. Supp. at 694. The court further noted that distribution costs are included in most retail prices. Id. So, too, are excise taxes which have been held to be includible in the taxable value of rings. See
justify the practice of taxing the load charge merely by pointing out that, since other items are also taxed at values which include costs of distribution, mutual fund shares need not be given the same treatment as regular securities. A far better explanation and rationale for the practice may be found in the differences between the mutual fund market and that of other securities.

When a regular security is traded, the broker's commission is an agent's fee for effecting the transaction between two private individuals and it does not involve the company whose shares are being traded. The initial cost of distribution of the regular security is incorporated into its original issuing price; but once the share is issued, all subsequent transactions are at a price which is unrelated to asset value, but which reflects the demand by the investor for the finite number of outstanding shares.

In comparison, the mutual fund share is continually issued at an asked price which includes the net asset value and the load charge. However, in nearly every case, the share will not be transferred between two private individuals.3 Thus, brokers will not act as agents for the investors at a private sale. Briefly stated, in the mutual fund context, there is no equivalent to the broker's commission. In ef-

Publcker v. Commissioner, 206 F.2d 250 (3d Cir. 1953), cert. denied, 346 U.S. 924 (1954) (excise tax on jewelry held to be a part of value for gift tax purposes); Duke v. Commissioner, 200 F.2d 82 (2d Cir. 1952), cert. denied, 345 U.S. 906 (1953); Estate of Gould, 14 T.C. 414 (1950) (excise tax held to be an element of value for estate tax purposes).

It is apparent that had the investor-donor or the investor-decedent not purchased the mutual fund shares, an equivalent amount of cash would have remained in his estate or would have been available for giving, and thus would have been taxed at its full dollar value. The taxpayer in the instant case offered no reason why the mere transformation of the cash asset into another less liquid form should markedly affect the taxable value, that is the replacement cost, of the non-cash asset.

23 An occasional allusion is made to a developing third market for mutual funds transactions between private individuals. The market described resembles the over-the-counter market for regular securities and emerges when the managers of the mutual fund cease to issue new shares because the fund has grown to a size which they consider to be larger than that which they can effectively manage, when they determine that further capital raised by the continued issuance of shares will not be as productive as they desire, or when they determine that, by further expansion, the fund may run afoul of restrictive statutory provisions. Although the fund does not issue new shares, it continues to redeem them and reserves the right to again issue shares in the future.

In this market, the shares have generally sold at a price above the public offering price of the shares prior to the time that the fund stopped issuing shares. This phenomenon seems to indicate that the asked price may fairly represent the market value of a mutual fund share, the approach of the Treasury regulations under discussion. See N.Y. Times, Dec. 15, 1967, at 73, col. 6. For a sample of the restrictive statutory provisions, see Investment Act, 15 U.S.C. § 80a-12; INT. REV. CODE OF 1954, § 851 (b) (4); Securities Exchange Act of 1934, 15 U.S.C. § 78p (a fund holding directly or indirectly more than 10 percent of any class of any equity security of an issuer registered under section 12 of the Act is subject to insider trading restrictions under section 16).
fect, the sale of mutual fund shares is tantamount to the continual new issuance of other types of securities, but with the mutual fund such issuance never develops into the more advanced stages of secondary trading. Here is the real reason why the taxpayer in Howell could not logically argue equivalency of the broker's commission and the load charge — none, in fact, exists. The load charge is a unique characteristic of a separate and distinct market, totally divorced from the market which exhibits fees for the effectuation of free negotiation, and such distribution costs must be included in the valuation in order to reflect the liabilities incurred by the mutual fund company prior to — and concomitant with — each new issuance.

The remainder of the court's opinion was essentially irrelevant to the actual holding. To the taxpayer's third argument, the court replied simply that quantity discounts are an economic way of life. They occur in the normal securities market and in the sale of most retail goods, as well as in the mutual fund market. Not noted by the court, but apposite to the argument, is the fact that gift taxes only apply to gifts in excess of $3,000. Thus, the argument of discrimination against the small investor still must legally fail, since the true small investor-donor would not pay tax at all.

Finally, the court rejected the argument that the load charge is the type of liability contemplated by the rule which permits the deduction of the value of outstanding liabilities from the value of an asset when determining the fair market value for gift tax purposes. As correctly noted by the court, a load charge is not the futuristic type of liability which the rule contemplates. The charge is an expense which has already been paid; not a debt due which transfers with the share. Indeed, at the time of the gift in the instant case,
the donor-taxpayer owned 100 percent of the equity in the property transferred.

From the examination and comparison of the major characteristics of the markets in which most securities are traded and that in which mutual funds are traded, it becomes clear that there does exist a valid underlying rationale for the difference in methods of valuation imposed by the Treasury regulations. The Treasury must be criticized, however, for fostering the ambiguity which hovers over the regulations in this area. Instead of simply publishing a regulation, the Treasury should outline the major technical and policy considerations which militate toward the scheme adopted in the regulation. Such a procedure would lend initial clarity to the reading of the regulation, and thus aid the tax practitioner in his own interpretation. Moreover, the courts would have a guidepost for later interpretation of the policy and intent underlying the regulation when it is subjected to attack or in need of being construed.

The Howell court may be commended only for its attempt to rationalize the regulations. As did the Tax Court in Estate of Wells,20 the Howell court strived to analogize the mutual fund share to assets, such as life insurance policies, which are similarly treated by the regulations.30 Each court, however, delved primarily into the analogous nature of the similar assets, not into the characteristics of their markets which are crucial for determining value. It is this latter standard, the trading market, which must be considered determinative in such cases.

In the past several years, mutual fund valuation procedures have come under an increasing amount of legislative scrutiny.31 Yet, little effective action has resulted, and it now appears that the only probable forum for a true challenging of the regulations is the

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20 50 T.C. No. 88 (Sept 16, 1968). For the discussion of the Wells decision, see note 7 supra.

30 See note 22 supra & accompanying text.


A proposed bill to change the regulations to value mutual funds at their public redemption price, H.R. 14,770, 90th Cong., 2d Sess. (1968), was introduced by Representative Pirnie on January 23, 1968. In support of his proposed legislation, Mr. Pirnie noted a similar resolution enacted by the Section of Taxation, American Bar Association, in July, 1966. 114 CONG. REC H255 (daily ed. Jan. 23, 1968). See also 19 ABA TAXATION SECTION 72 (July, 1966); 20 ABA TAXATION SECTION 7 (April, 1967).

The general scheme proposed by the bar was to use public redemption value; however, Mr. Pirnie inserted a provision to value the shares at the redemption price or at the value of the actual proceeds from the sale, whichever was the higher value. This latter provision was to compensate for the developing third market in the select mutual funds discussed earlier. See note 23 supra.
courthouse. Nonetheless, it is submitted that, in light of the characteristics of the trading market, the regulations as presently constituted are perfectly defendable and acceptable. Therefore, if the Treasury would learn from this example and, in the future, more clearly define the basis for its regulations, the time and expense of Howell-type litigation could thereby be mitigated.

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