SCHOOL OF LAW
CASE WESTERN RESERVE
UNIVERSITY

Case Western Reserve Law Review

Volume 13 | Issue 2

1962

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additional compensation to the employee, and that the employee realized income in each of the years the option was exercised by the wife.

SUMMARY

Recapitalizations, undertaken for legitimate business purposes, and "preferred stock bail-outs," followed by a gift or other disposition of the thinned-down equity, will facilitate a shifting of control of the family business without necessarily incurring adverse tax consequences. In particular, the utilization of section 306 stock for estate planning purposes should not be overlooked, for only too frequently this stock is condemned when in fact it can afford very desirable flexibility without any "practical" tax disadvantages. A third method of shifting control involves the issuance of additional stock to key employees through the possibility of the "restricted stock option" procedure. However, if the requirements for a "restricted stock option" are not met, this course may be a dangerous one.

VI

PARTICIPATION IN THE FORMATION OF A MUTUAL FUND AFTER DISPOSITION OF THE BUSINESS DURING THE OWNER'S LIFETIME

Sterling Newell, Jr.*

INTRODUCTION

The owner of a family business may at some point during his lifetime decide to dispose of the family business before his death. Having reached this conclusion, he must then determine the form in which the transaction is to be cast. If a larger corporation is interested in acquiring the family business, it may be able to negotiate an exchange of the owner's stock in the family business or of the assets of the family business for stock of the acquiring corporation. If this exchange qualifies for the special tax treatment afforded by the reorganization provisions of the Internal Revenue Code, the exchange may be accomplished in large measure tax free.[1]

* The author acknowledges the assistance rendered by his associate, Richard T. Watson, in the preparation of this article.

1. INT. REV. CODE OF 1954, § 368(a)(1)(A), merger or consolidation; § 368(a)(1)(B), stock for stock; § 368(a)(1)(C), stock for assets [hereinafter cited as CODE §]. The tax-free exchange is treated in CODE §§ 351-68. See generally, *Baker, Continuity of Interest*

Alternatively, the owner of the family business might decide to arrange for a redemption of his stock in the family corporation as a means of conveying his interest to the other shareholders.[2] Or he might sell his stock to the other shareholders, to members of his family, to employees of the family business, or perhaps to complete outsiders. Such transactions normally involve the imposition of a tax on the gain realized although the recognition of the gain may be deferred and spread over a number of years by use, for example, of a private annuity.[3]

The reorganization and redemption sections of the Internal Revenue Code and private annuities have been the subject of extensive analysis. This article will examine a relatively new technique, the possibility of tax free diversification after a disposition of the family business which qualified as a reorganization.[4]

The Objective: Diversification Without Taxation

If the owner of the family business disposed of the business in a transaction which qualified for the special tax treatment afforded by the reorganization provisions of the Code he may, at the conclusion of the transaction, hold a substantial block of stock in the acquiring corporation at a relatively low basis.[5] Subsequent sale of this stock in order to achieve diversification would lead to a heavy capital gains tax, but retention of the stock of the acquiring corporation might be undesirable from an investment point of view. At this point the former owner's objective, briefly stated, is tax free diversification. One possible means of achieving this result is through participation in the organization of a "mutual fund."

PARTICIPATION IN THE FORMATION OF A MUTUAL FUND

The theory of the transaction involved is rather simple. A number of individuals who hold substantial blocks of different highly appreci-

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Requirement in Reorganizations Re-examined — the Hickok Case, N.Y.U. 18TH INST. ON FED. TAX 761 (1960); BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 357 (1959); Calkins, *et al., Tax Problems of Close Corporations: A Survey,* 10 WEST. RES. L. REV. 144 (1959); Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions,* 70 HARV. L. REV. 1183 (1957); Merritt, *Tax Free Corporate Acquisitions — The Law and the Proposed Regulations,* 53 MICH. L. REV. 911 (1955).

2. CODE § 302. See generally BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 223 (1959); Brown, *Selected Problems in Stock Redemptions,* U. SO. CALIF. 1959 TAX INST. 171; Herwitz, *Stock Redemptions and the Accumulated Earnings Tax,* 74 HARV. L. REV. 866 (1961); Kohn, *Capital Gain Problems in Particular Areas — Dispositions of Corporate Stock,* 12 WEST. RES. L. REV. 310 (1961).

3. See generally Ekman, *Private Annuities,* 22 OHIO ST. L.J. 279 (1961); Farmer, *Divesting Growth Potentials in Estate Planning,* U. SO. CALIF. 1961 TAX INST. 437; McGiveron & Lynch, *Private Annuity Laws Are Practical Now as Tax Treatment Grows More Certain,* 10 J. TAXATION 322 (1959).

4. Treatment of a transaction as a reorganization is not always to the taxpayer's advantage. See, *e.g.,* Commissioner v. Morgan, 288 F.2d 676 (3d Cir. 1961), *cert. denied,* 30 U.S.L. WEEK 3113 (U.S. Oct. 10, 1961); Rev. Rul. 61-156, 1961 INT. REV. BULL. NO. 34, at 10.

5. CODE § 358.

ated securities, by means of an escrow created for the purpose, simultaneously transfer these securities to a mutual fund organized for the purpose of receiving them. In exchange, the individuals receive shares of the mutual fund. The number of shares of the mutual fund received by each individual is usually based on the market value as of the date of exchange of the securities he transfers to the fund.

Advantages

It would appear that such a transaction falls squarely within the provisions of section 351, which provides:

> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation.

If section 351 applies, no gain will be recognized by the individuals involved on the exchange of their appreciated securities for shares of the mutual fund. They will thus have achieved diversification accompanied by professional management without incurring a capital gains tax.

Each individual's basis for his shares of the mutual fund will be the same as his basis for the securities he exchanged with the fund.[6] The fund's basis for the securities transferred to it will be the same as the basis of the securities in the hands of their transferor.[7] Thus, if owner exchanges 1,000 shares in the acquiring corporation with a basis of $1.00 per share and a current market value of $100.00 per share for 1,000 shares of the fund, owner's basis for his new shares of the fund will be $1.00 per share and the fund's basis for its shares in the acquiring corporation will be $1.00 per share.

Disadvantages: Investment Considerations

As most of the securities transferred to such a fund will have been highly appreciated in the hands of the individual shareholders of the fund, the current market value of the securities comprising the fund's initial portfolio will in most cases greatly exceed the fund's cost basis for these securities. This means that the sale by the fund of almost any security in its initial portfolio will lead to the realization of substantial capital gains. This fact in and of itself may lead to the retention in the fund of securities the disposal of which would be indicated by normal investment considerations. Moreover, the composition of the fund itself may, to a degree, reflect the securities available for transfer to such a fund rather than the balance an investment fund manager might normally

6. CODE § 358.
7. CODE § 362.

seek. However, both these considerations may be outweighed by the desirability of obtaining at least some diversification.

Disadvantages: Tax Consequences of "Pooling" of Unrealized Capital Gains

As has previously been indicated, the number of shares of the mutual fund received by the individuals who participate in its organization is determined on the basis of the market value of the securities transferred by the individuals to the fund. No adjustment is made for the varying degrees of unrealized appreciation inherent in these securities despite the fact that this appreciation represents a potential capital gains tax liability for the fund's shareholders. When the fund realizes capital gains upon the sale of these appreciated securities, the resultant capital gains tax is apportioned among the shareholders of the fund according to the number of shares of the fund they own. This apportionment ignores the extent to which prior appreciation of the fund's securities in the hands of its shareholders contributes to the capital gain realized by the fund.[8] The shareholders are thus in effect pooling their capital gains.

As a result, a shareholder of the fund who exchanged securities with a relatively low appreciation ratio will in effect pay more than his fair share of the capital gains incurred by the fund. Theoretically, this disparity will be compensated for when the shareholder disposes of his shares in the fund because the tax paid by the shareholder on capital gains realized by the fund in effect reduces the tax payable by the shareholder when he disposes of his shares.

Most mutual funds elect to be taxed as regulated investment companies under Subchapter M of the Internal Revenue Code. A regulated investment company may handle realized capital gains in one of two ways: First, it may retain the realized capital gain and pay the tax thereon, thereby reducing the net asset value of the fund by one-quarter of the realized capital gain. If this is done, the shareholders of the fund increase their cost bases in their shares by three-quarters of the capital gain realized. Second, it may distribute realized capital gains, thereby reducing the net asset value of the fund by the entire amount of the capital gain realized. In this event, the shareholders pay the tax and make no adjustment in the bases of their shares in the fund.[9]

Thus, whether the fund retains realized capital gains or whether it distributes them, the effect of the realization of capital gains by the fund

8. In contrast, the Securities and Exchange Commission requires that an existent mutual fund which exchanges shares of the fund for the assets of a personal holding company discount the value of the assets of the personal holding company for the purpose of the exchange if the assets of the personal holding company are more highly appreciated than those of the fund. See the discussion in *Shop Talk,* 14 J. TAXATION 190 (1961).

9. CODE § 852.

is to narrow the gap between the net asset value per share of the fund and the per share basis of the individual shareholders of the fund by the amount of the shareholder's allocable portion of the gain realized. This reduces the shareholder's unrealized appreciation in his shares of the fund. As a result, while such a shareholder pays more than his share of the capital gains tax resulting from sale of the appreciated securities in the fund's portfolio, the effect of his doing so is to reduce the amount of capital gains tax the shareholder will have to pay on the sale of his shares of the fund.

However, continued realization of capital gains by the fund will in time lead to a situation where some shareholders will have a cost basis for their shares of the fund equal to the fund's net asset value per share. Thereafter, realization of capital gains by the fund will have the effect of decreasing the net asset value of the fund's shares to less than the shareholder's basis (or increasing his basis to more than the net asset value per share). As a result, such a shareholder will realize less net after tax proceeds upon selling his shares of the fund than he would have realized had he sold his own shares of appreciated securities rather than transferring them to the fund. If such a shareholder can utilize the capital loss deduction resulting from the sale of his shares in the fund at less than their basis, his loss will be compensated for by the resultant tax savings. Otherwise, at all times after the shareholder's basis for his shares in the fund reaches the fund's net asset value per share each $1.00 of capital gains realized by the fund and attributable to such a shareholder will result in a twenty-five cent loss to the shareholder, assuming him to be in the fifty per cent bracket.[10]

It should be emphasized that this problem will become acute immediately upon the death of a shareholder in the fund. At this point the shareholder's legatees will receive a stepped-up basis for the fund shares and be placed in the position of having a basis equal to the net asset value of the shares.[11] Thereafter, realization of capital gain by the fund will have the effect described above. This suggests the wisdom of tendering the shares of such a fund to the fund for redemption as soon as practicable after the death of a shareholder. Instructions to this effect might well be included in the will of a shareholder in such a fund.

Moreover, if the above analysis is correct, there may be a snowballing effect attendant to the redemption of shares in the fund. As there is no incentive for individuals to purchase fund shares for cash,[12] the primary

10. See Appendix I, *infra.*

11. CODE § 1014(a).

12. A purchaser for cash of shares in such a fund would immediately have a cost basis equal to the net asset value per share of the fund (ignoring purchase expense) with the possible disadvantages discussed above. These disadvantages differ, however, only in degree from those attendant to the purchase of shares in any mutual fund that holds appreciated securities.

assets available to the fund for the purpose of redeeming its shares will be the appreciated securities held by the fund.[13] Thus, if shareholders request redemption of their shares, it may be necessary for the fund to sell appreciated securities; additional capital gains will thereby be realized, leading perhaps to additional requests for redemption, leading to additional capital gains and so forth. This danger has been noted and provision made for redemptions in kind by some of the funds.

IRS Attitude

Finally, there is the matter of the Internal Revenue Service's attitude. Prior to February 15, 1961, a limited number of Revenue Rulings were obtained to the effect that participation in the organization of a mutual fund pursuant to section 351 in the manner above described did not involve the recognition of gain.[14] However, the Service has announced that it will not issue rulings in connection with requests filed subsequent to February 16, 1961.[15] It has been suggested that the Service's refusal to issue rulings may be overcome by the use of a closing agreement.[16] This appears unlikely[17] and, accordingly, any participation in such fund must be based on one's judgment as to the Service's attitude and the possible results of litigation.

There has been some dispute as to the implications of the Service's refusal to continue to issue rulings. The Commissioner of Internal Revenue recently made the following observations:

> The Service had issued some rulings holding Section 351 applicable in the organization of particular investment funds. On further analysis, however, it was concluded that this type of transaction could more properly be regarded as a method for unduly circumventing the capital gains tax. It was then decided, in the interests of wise administration of the tax laws, to issue no further rulings.
>
> At the date of the announcement of this decision, several other funds had applications pending and, in view of two considerations, we reluctantly agreed that rulings would be given in these cases. First, there were very serious competitive advantages and disadvantages involved — certain funds with rulings were in a position to attract customers of other

13. To the extent that shareholders of the fund elect to receive distribution of income and/or capital gains in shares of the fund rather than in cash, such retained cash would be available for the redemption of shares. Electing to receive shares of the fund rather than cash is, of course, in effect the same as buying shares for cash and presents the possible disadvantageous consequences discussed above.

14. See address by Mortimer M. Caplin, Commissioner of Internal Revenue, before the Tax Executives Institute at San Francisco, California, on August 14, 1961, reported in P-H 1961 Fed. Tax ¶ 54904.

15. Rev. Proc. 60-6, 1960-1 CUM. BULL. 880, as amended, T.I.R. 311, 7 CCH 1961 STAND. FED. TAX REP. ¶ 6311 (March 3, 1961).

16. P-H 1961 FED. TAXES ¶ 32130 (March 9, 1961).

17. Treas. Reg. § 601.202(d) (1960).

funds without rulings. Second, was the fact that the administrative conclusion here was to discontinue the issuance of rulings rather than to rule adversely.

Had it been decided to rule adversely on these transactions in the future, no favorable rulings would have been issued on the pending applications.[18] (Emphasis added.)

While the Commissioner's future course of action remains somewhat in doubt and the success which he would enjoy in the event of a determination to attack these transactions is uncertain, it may at least be said that the Commissioner's attitude toward tax free diversification is less than benign. Absent special considerations, it would appear that only the former owner of a family business who is advanced in age, who holds highly appreciated securities, and who has provided his executor with explicit instructions and authority to sell should consider participation in the organization of such a fund. This conclusion is supported both by the present uncertainties surrounding the formation of the fund itself and by the unfortunate consequences which may flow from the pooling of capital gains.

APPENDIX

I. The following illustrates the effect of "pooling" capital gains:

(a) A holds 1,000 shares X Corporation with: Basis (per share)	$100	B holds 1,000 shares Y Corporation with: Basis (per share)	-0-
Current market value (per share)	$100	Current market value (per share)	$100
Net after tax value to A if shares are sold	$100,000	Net after tax value to B if shares are sold (proceeds of sale less tax)	$75,000

(b) A and B organize a mutual fund by exchanging their shares of X and Y for 1,000 shares each of the fund:

Current market value of assets of fund	$200,000
Net asset value per share of fund	$100
Fund's basis for 1,000 shares of X per share	$100
Fund's basis for 1,000 shares of Y per share	-0-
A's basis for his 1,000 shares of fund per share	$100
B's basis for his 1,000 shares of fund per share	-0-

18. Address by Caplin, *op. cit. supra* note 14.

(c) Fund sells the 1,000 shares of Y:

Cash proceeds	$100,000
Basis	-0-
Capital gain	$100,000
Capital gain per share of mutual fund	$50

II. If fund distributes $50,000 capital gain to each shareholder:

(a) Fund's assets will be:

1,000 shares of X at $100	$100,000
Net asset value per share of fund	$50

(b) Value of A's holding would then be:		Value of B's holding would then be:	
1,000 shares of Fund at $50	$50,000	1,000 shares of Fund at $50	$50,000
Cash (capital gain distribution less tax)	$37,500	Cash (capital gain distribution less tax)	$37,500
Value of holding	$87,500	Value of holding	$87,500
(c) A's original net value (from I (a))	$100,000	Value of B's holding	$87,500
Value of A's holding	$87,500	B's original net value (from I (a))	$75,000
A's potential loss	$12,500	B's potential profit	$12,500
(d) A's total basis for his 1,000 shares of the fund	$100,000	Value of 1,000 shares of the fund	$50,000
Value of 1,000 shares of the fund	$50,000	B's basis for his 1,000 shares of the fund	-0-
A's potential loss on sale	$50,000	B's potential gain on the sale	$50,000
A's tax saving therefrom (if capital loss may be utilized)	$12,500	B's potential capital gains tax	$12,500

III. If fund retains the capital gains and pays the tax thereon:

(a) Fund's assets will be:

1,000 shares of X at $100	$100,000
Cash (proceeds of sale of shares of Y less tax)	$75,000
Total assets	$175,000
Net asset value per share	$ 87.50

(b) Value of A's holding will be:		Value of B's holding will be:	
1,000 shares of fund at $87.50	$87,500	1,000 shares of fund at $87.50	$87,500
(c) A's original net value (from I (a))	$100,000	Value of B's holding	$87,500
Value of A's holding	$87,500	B's original net value (from I (a))	$75,000
A's potential loss	$12,500	B's potential profit	$12,500