achieved one of its principal aims: to make investment company management a skilled and an honorable profession.[266]

Nevertheless, the Wharton and Special Study Reports questioned the adequacy of the less thoroughgoing protections afforded investors by the Act in the advisory fee, sales compensation, and brokerage commission areas. These questions were brought to the fore by the growth of the mutual fund industry to an extent unforeseen when the Act was passed in 1940. Sales loads, advisory fees, and brokerage commissions may not have provided substantial emoluments in the one-half-billion-dollar mutual fund industry of 1940, but they are most significant in the **$38** billion industry of today. Gross sales charges paid by mutual fund purchasers in 1965 are estimated at over **$260** million, while total advisory fees paid by the funds amounted to an estimated **$130** million. And mutual fund portfolio transactions generated an estimated $100 million of brokerage commissions in that year.[267]

Sales loads paid by purchasers of fund shares are the most important single expense of investing in a mutual fund.[268] Advisory fees are the most substantial expenses incurred in the operation of the funds and are continuing costs which must be borne by fund shareholders regardless of the profitability of their investments.[269]

F. SALES LOADS, ADVISORY FEES, AND BROKERAGE COMMISSIONS

1. The findings of the Wharton Report and the Special Study

The Wharton Report analyzed the relationship of mutual fund growth to the level of sales loads and advisory fees and the allocation of fund brokerage commissions. It concluded that potential conflicts of interest in these areas were among the "more important current problems" in the mutual fund industry.[270] The Wharton Report's conclusions with respect to sales loads and brokerage commissions were reinforced by the findings of the Special Study.[271]

The Wharton Report found evidence to indicate that the higher the sales load, the larger the fund or fund complex. The Report noted that "* * * many of the larger [mutual fund] systems * * * have found that high retail commissions, which induce greater selling effort, tend to increase the rate of sales of investment company shares." [272] The Special Study found that factors peculiar to the mutual fnnd industry—particularly the front-end load in the sale of contractual

[266] Speaking on the Commission's behalf to the Senate Committee on Banking and Currency, the late Commissioner Healy said: "This bill will, I believe, promote the dignity of investment trusts. The management of these institutions is worthy of being a separate profession and a separate charge in itself, instead of being a mere adjunct to some other lines of business. What we ought to develop is a group of expert investment trust managers who * * * make their profits * * * from wise and careful management of the funds entrusted to them." Senate Hearings 47.

[267] Source: Investment Company Institute.

[268] A sales load is charged not only on the investor's initial purchase of fund shares, but on his subsequent purchases. Although no sales load is charged on purchases of additional shares made through the reinvestment of capital gain distributions, many funds do charge a sales load in connection with purchases attributable to the reinvestment of ordinary income dividends. Investors who purchase mutual fund shares through contractual plans, voluntary accumulation plans and capital gain and dividend reinvestment plans on which a sales load is not charged, may nevertheless incur other fees. However, these other fees are usually paid to the funds or to banks and not to the group selling the shares. They are unposed to defray the cost of administering the plans.

[269] In some cases, the basic advisory fee pays for all the normal operating serviees required by the funds. Most funds, however, incur operating expenses, in addition to the basic advisory fee. The most significant of these expenses are the costs of custodial, stock transfer and dividend disbursing services and of distributing periodic reports and proxy material to shareholders. In most instances, banks and other unaffiliated persons perform these services at rates that are negotiated with the fund managers, . In some instances, these services are supplied or paid for by the adviser or underwriter in return for additional fees.

[270] Wharton Report 3.

[271] Speaial Study, pt. 4, 107–110, 121–234.

[272] Wharton Report 31.

plans—created pressures toward undesirable selling practices. It concluded that the "evidence suggests the existence of such practices to an unfortunate degree." [273]

The growth of the funds through the sale of new fund shares increases the compensation of those who manage them, execute their portfolio transactions and sell their shares. However, the Wharton Report questioned whether the industry's emphasis on growth through sales has benefited the funds and their shareholders from the viewpoint of investment results. Its analysis of fund performance indicated that investment results mere not related to size. The Report stated:

> A priori it has been argued that shareholders benefit from increased diversification or (sic) risk and the ability of the adriser to afford more substantial facilities and able personnel; but it has been pointed out on the other side that small or moderate sized portfolios contribute to flexibility of portfolio adjustments in the light of changing. circumstances. Since neither average performance nor variability of performance has been significantly related to size of fund, neither of these considerations appears to have been decisive.[274]

The Wharton Report pointed out, however, that growth through sales can be of benefit to fund shareholders. It noted that the economies of size stemming from such growth could make for lower costs per dollar of assets managed.[275] But it questioned whether investment advisers had adequately shared these savings with the funds and their shareholders.[276] Despite the substantial growth of the funds since 1940, the Report found that the effective fee rates charged mutual funds tended to cluster heavily about the traditional annual rate of one-half of 1 percent of average net assets.[277]

The Report observed that "advisory fee rates charged open-end companies by investment advisers are both significantly higher and significantly less responsive to changes in the volume of assets supervised than is the case with those advisers' nonfund clients or with open-end company assets managed internally by boards of directors or trustees." [278]

The Wharton Report suggested that the practice in the mutual fund industry of paying for management services by fees based on a percentage of assets tends to avoid conventional limitations on executive salaries. The lack of such limitations was alluded to as a possible partial explanation of the higher management costs of the externally managed funds as against those that are internally managed. The Report also noted that the attachment of the officers and directors of the funds to the organizations which supply services to the funds may tend to obscure their awareness of their fiduciary relationship to the funds and their shareholders.[279] It stated that consideration for the interests of the funds' shareholders may be particularly lacking in connection with sales of fund shares.[280]

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[273] Special Study, pt. 4, 204-212.
[274] Wharton Report 31-32.
[275] Wharton Report 492.
[276] Wharton Report 493-494.
[277] As previously noted, a significant number of advisory contracts now provide for a decline in the rate of the advisory fee as the size of the assets managed rises. See p. 46, supra, and pp. 100-102, infra.
[278] Wharton Report 491.
[279] Wharton Report 493-494.
[280] Wharton Report 31-33.

Both reports observed that a substantial portion of mutual fund brokerage commissions was used to give broker-dealers extra compensation for selling fund shares. To the extent that brokerage commissions were used to pay for investment research and other services available from brokers, they served mainly to assist the investment adviser in fulfilling his obligations under the advisory contract. In instances where the adviser-underwriter was affiliated with a broker, the affiliated broker tended to obtain a substantial portion of the fund's brokerage. In neither case did the Wharton Report find that the advisory fee was reduced to reflect the benefits and profits realized by the investment adviser from the brokerage commissions paid by the funds.[281]

The Wharton Report thus suggested that the problems found in the areas of sales loads, advisory fees and portfolio brokerage might be attributable to the structural characteristics of the mutual fund industry. Although the funds are legally separate entities, they are under the effective control of their investment advisers and principal underwriters. This control starts with the formation of the investment company at the initiative of a group which intends to and does furnish the fund with its essential services. Almost invariably the organizers of the fund become its key executive officers and—to the extent permitted by the Act—its directors. The organizers also select the unaffiliated directors. Although the fund may grow to substantial size and achieve a national reputation, the use of external organizations to perform its essential services eliminates any necessity for expanding the fund's own organization. The fund remains, as it always was, without an identity and an organization separate from its adviser-underwriter. The fund occupies the offices of the adviser-underwriter, uses the latter's staff and executive officers, and generally obtains legal and auditing services from the same attorneys and accountants who serve the adviser-underwriter.[282]

Seldom is there a disinterested voice in the management of the fund other than that of the unaffiliated directors. But the Wharton Report concluded that the unaffiliated directors "may be of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser." [283]

In this connection, it should be noted that the unaffiliated directors' ability to bargain with the adviser-underwriter may be hampered by the practical difficulty of changing from one adviser-underwriter to another. Such a change might disrupt existing operations and defeat the expectations of some shareholders who may have purchased their shares in reliance on existing management. Under these circumstances competition can play little part in the selection of mutual fund adviser-underwriters.[284]

The Wharton Report concluded that the shareholder voting rights provided for in the Act "appear to be of limited value" in governing the relationships between the funds and their investment advisers, principal underwriters and regular brokers.[285] It found that mutual fund shares are more widely distributed and their ownership less con-

[281] Wharton Report 32–33, 528, 530–537. See also Special Study, pt. 4, 218, 233.
[282] Wharton Report 33–36, 66-67.
[283] Wharton Report 34.
[284] *Cf.* Wharton Report 67.
[285] Wharton Report 34.

centrated than those of most other publicly held companies of comparable size.[286] Coupled with the wide diffusion of shareownership is the redemption feature which facilitates the exit from the fund of shareholders who are dissatisfied with management performance. For these reasons, the Wharton Report observed, mutual fund shareholders tend to be passive. Generally, only a handful of them attend annual meetings, despite the efforts by some fund managements to encourage attendance.[287]

2. Public policy implications of the Wharton and Special Study Reports

Because of the provisions of the Act designed to protect the interests of mutual fund shareholders through representation by unaffiliated directors and through special disclosure and shareholder approval requirements: investment company shareholders have more of an opportunity to participate in the affairs of their companies than shareholders of most other publicly held corporations. If, as the Wharton Report suggested, these provisions have been ineffective, does this failure raise significant questions of public policy? Some say not.

In one sense, the economic relationship of fund managers to fund shareholders differs from that of other corporate managers to their shareholders. Most business corporations derive their revenues and profits by selling their products or services to outside customers at prices and upon terms ordinarily determined by arm's-length bargaining in competitive markets. It is in the interest of stockholders and management alike to maximize profits from such sales. The outside customers are protected not by the company but by their ability to fend for themselves and by consumer-oriented laws. A mutual fund, however, has no products and no customers, unless one regards its shares as its products and its present and potential shareholders as its customers. If the situation is looked at from the viewpoint of the investment advisers, they are in business of selling their advisory and, in some cases, their brokerage services to the public through the shares of the funds they manage. As pointed out above, frequently they also serve as, or are closely affiliated with, the principal underwriters of the funds' shares in order to merchandise these shares actively and aggressively.

These circumstances lead some to suggest that any conflicts that may exist between the interests of the fund managers and underwriters and those of their customers—the mutual fund investors—are no different from the usual conflicts of interest between buyers and sellers. The managers' responsibilities to mutual fund investors are viewed as essentially the same as those of an investment adviser to his nonfund clients. Those who take this view suggest that conventional concepts of corporate and trust law are inapplicable to the mutual fund because it is merely a "shell" organized for administrative convenience as a vehicle by which the investment adviser undertakes the management of funds entrusted to him by individual

[286] Wharton Report 64.

This finding must now be qualified to some extent. One month after the Wharton Report was transmitted to Congress in August of 1962, The Fund of Funds, Ltd., a fund holding company was organized under Ontario law. Fund of Funds is itself a mutual fund which invests in the securities of other investment companies and mutual fund management companies. It claims its shares are not sold within *the* jurisdiction of the United States and that it is, therefore, immune from regulation under the Act. As of June 30, 1966, its assets amounted to $420 million, and it now holds substantial positions in a number of United States mutual funds. See pp. 312-324, infra.

[287] Wharton Report 64.

investors. To them, the fund itself has little or no independent significance for it is essentially the brand name under which a particular investment adviser sells its services to the public. Adherents to this position point out that every mutual fund investor receives a prospectus that gives him an accurate description of the nature of the services being offered and an explanation of their costs, and that dissatisfied shareholders can exercise their right of redemption.

If this view were accepted, the questions raised by the Wharton Report and the Special Study with respect to advisory fees, sales loads, and utilization of portfolio brokerage might be of little significance.

The Commission believes that it would be most unwise *to* accept the foregoing analysis for regulatory purposes. It is clearly rejected in the Act. The courts also have held that mutual fund shareholders **are** not merely individual advisory clients, and that the funds have rights that can be enforced by their shareholders just as other types of corporations have rights that can be enforced by their shareholders.[288] If mutual fund shareholders are viewed as customers to whom the advisers and the underwriters sell their services and products, the shareholder protections provided by the fiduciary principles of corporation law tend to disappear. There is no adequate substitute for those principles. The individual mutual fund shareholder cannot bargain over the level of the sales load, the terms of the advisory contract or the utilization of portfolio brokerage. If by reason of the industry structure, there is no one in a position to bargain effectively with respect to these matters, and if competition cannot operate as an effective control, then fundamental questions of public policy are raised.

Mutual funds may differ to some extent from other types of business associations in which those who administer the enterprise manage other people's money. But in the Commission's opinion those differences make it all the more essential that principles long regarded as basic in the law of corporations and trusts be applied to the funds.

Although mutual fund investors buy the fund managers' professional investment skills, those who purchase other equity securities also buy the skills of the issuers' managers. One mho invests in shares of other publicly held corporations relies on the expertise and the diligence of their managers in much the same way as the mutual fund shareholder relies on the expertise and the diligence of the funds' managers. In these corporations conventional limitations on executive compensation, disclosure and fiduciary standards of reasonableness all serve as restraints.

Full disclosure is basic to all Federal securities legislation and is as crucial to the protection of mutual fund investors as it is to the protection of investors generally. It is, hon-ever, only an aspect of, riot a substitute for, the right of equity security holders to fair treatment and adherence to fiduciary standards of conduct from those who manage and control their businesses. The advisory fees, the underwriting compensation, and the brokerage commissions paid to the manager? of externally managed funds may differ somewhat from the salaries, bonuses, and stock options that other corporations give to

[288] *Taussig* v. *Wellington Fund, Inc.*, 187 F. Supp. 179, 195–197 (D. Del. 1960), *affirmed*, 313 F. 2d 472 (C.A. 3, 1963) *certiorari denied*. 374 U.S. 806. See also *Saminsky* v. *Abbott*, 185 A. 2d 765, 770–772 (Dol Ch., 1961). For further discussion see pp. 132-133, infra.

their managers. While both situations involve compensation for managerial services, payments for services furnished to mutual funds may involve in addition some compensation for entrepreneurial risk. However, total immunity from economic and legal restraints would be as undesirable in one case as in the other.

The contention that redeemability obviates the need for other shareholder protections is also questionable. Those who hold shares in other publicly held companies can sell them on an exchange or in the over-the-counter market. Yet the free alienability of these shares has never been viewed as lessening the responsibility of corporate managers to deal fairly and equitably with the shareholders. Particularly should this be so in the case of mutual funds whose shareholders usually pay considerably more to acquire their shares than other types of investors pay for both the acquisition and the sale of their shares.[289]

As stated in the Act, a primary purpose of its provisions is to mitigate and, insofar as is feasible, to eliminate those conditions whereby investment companies were being operated in the interests of their promoters, managers, underwriters, brokers, and other insiders rather than in the interests of all classes of security holders.[290] In large part, these provisions have operated effectively against the major abuses prevalent in the investment company industry prior to 1940. Questions as to the extent to which the growth of mutual funds since 1940 has accentuated problems that may then have been minor and as to the effectiveness of the Act in dealing with such problems merit careful and serious analysis. This report attempts such an analysis.

[289] See pp. 53-54, supra, and pp. 209-214, infra.
[290] Sec. 1(b)(2).

APPENDIX

SPECIAL TAX TREATMENT OF DIVERSIFIED INVESTMENT COMPANIES

This appendix summarizes various provisions of the Internal Revenue Code of 1954 ("the Code") applicable to diversified investment companies. These provisions are found in subchapter M of the Code,[1] which applies only to so-called regulated investment companies and which states that no company shall be considered a "regulated" investment company unless it meets certain standards of diversification set forth in the Code.[2] The Code's standards of diversification are similar to but not precisely the same as those of the Act.[3]

A. ORDINARY INCOME

Regulated investment companies that distribute at least 90 percent of their ordinary taxable income to their shareholders can deduct such dividends from ordinary income.[4] Since most corporations cannot deduct the dividends that they pay their stockholders from taxable income, this provision is significant to diversified investment companies and to their stockholders.[5]

Thus, if an investment company has a taxable annual income of $1 million, all of which is derived from interest, but does not qualify for subchapter M treatment, it must pay a Federal corporate income tax of $473,500[6] and will have only $526,500 available for distribution to its stockholders or retention in its business. But if the company qualifies for subchapter M treatment, and if it distributes $900,000 of its million dollar income to its stockholders, it will be able to deduct that entire $900,000 from its taxable income. Its taxable income will then be $100,000, and its corporate income tax $41,500, leaving $58,500 for retention and reinvestment. Because the company qualified for subchapter M treatment its stockholders received $373,500 ($900,000 minus $526,500) more than they could possibly have received if the company had not so qualified. Moreover, the company can avoid the corporate income tax altogether by electing to distribute **all** of its income to its stockholders. If it does that, it **will** have no taxable income and will have passed its entire income on to its stock-

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[1] Code secs. 851-855.

[2] Code, sec 851(b) (4).

[3] As noted at pp. 40-41, supra, the Code treats a company which has 50 percent of its assets in diversified securities as "diversified" whereas a company is not "diversified" under the act unless 75 percent of its assets are in diversiiied securities. Because of this factor a number of companies that are "non-diversified" under the Act are nevertheless "regulated investment companies" entitled to the benefits of subch. M.

The tau status of the contractual plan type of unit investment trust (see pp. 57-58, supra) is the same as that of the diversified type of management company. This is so because: (1) Such trusts usually invest ail of their assets in the shares of a single open-end management company; and (2) sec. 851(b)(4)(B) of the Code imposes no limitation on the portion of its assets that a "regulated investment company" can invest in the securities of other regulated investment companies.

[4] Code, sec. 852.

[5] See Code, secs. 161-182, 241-248.

[6] All calculations are based on the rates applicable to taxable years after Dec. 31, 1964, i.e., 22 percent on the first $25,000 of a corporation's income and 48 percent on so much of a corporation's income as exceeds that figure. Code, sec. 11.

holders free from any Federal corporate income tax. This is exactly what most diversified investment companies do.[7]

The foregoing example dealt with interest income. In the case of dividend income the tax advantage of the subchapter M investment companies is much less. This is so because all corporations are entitled to deduct from their taxable income 85 percent of any dividends that they receive.[8] Hence only 15 percent of the dividend income of a corporation is ever subject to Federal corporate income tax.[9] Since the highest rate at which corporate income is taxed is 48 percent, the maximum effective Federal corporate income tax rate on dividend income is only 7.2 percent (48 percent of 15 percent). Of course, the ability to avoid a 7.2 percent income tax is still a substantial advantage. The extent of that advantage in the case of a company with dividend income of $1 million is shown below:

	Subchapter M investment company	Company not qualified for subchapter M treatment
Dividend income	$1,000,000	$1,000,000
Intercorporate dividend exclusion	[a] None	850,000
Dividends paid deduction	1,000,000	None
Taxable income	None	150,000
Federal corporate income tax	None	[b] 65,500
Maximum amount available for distribution to stockholders	1,000,000	[c] 934,500

[a] Regulated investment companies that avail themselves of the benefits of subch. M are not entitled to the intercorporate dividend deduction. Code, sec. 852(b)(2)(C).

[b] The effective rate of tax in the foregoing illustration is 6.55 percent rather than 7.2 percent as stated in the text because the first $25,000 of dividend income is taxed at only 3.3 percent (15 percent of the corporate normal tax rate of 22 percent).

[c] To obtain its $65,500 tax saving the subch. M company had to distribute its entice income to its stockholders, while the managers of the company that did not choose to qualify for subch. M treatment were free to retain a portion of its after-tax income in the business.

A dividend that the recipient invests in the purchase of additional shares is deemed to have been paid by the company and to have been received by the stockholder. Hence the dividend reinvestment programs maintained by most mutual funds do not affect their ability to avail themselves of the benefits of subch. M These programs make it possible for mutual funds to add appreciable portions of their income to capitai without forfeiting the tax advantages conditioned on the distribution of such income to the shareowners.

B. CAPITAL GAINS

1. Capital gains distributed to the shareholders

Regulated investment companies are exempt from any corporate income tax on capital gains that they distribute to their shareholders.[10] The gains so distributed are taxable to the shareholders as capital gain, not ordinary income.[11] Since most corporations have to pay a 25 percent tax on their long-term capital gains,[12] and since investment companies frequently realize capital gains—indeed most of them regard the realization of such gains as one of their principal objectives—the capital gain treatment that subchapter M gives to investment companies, that qualify thereunder, is a substantial tax

[7] The Code contains so-called "look back" provisions (sec. 855) which permit the investment company to review its situation after the close of the taxable year, declare such postclosing dividends as it deems appropriate in the light of such review, and then deduct such dividends from its taxable income for the previous year. Dividends declared at any time prior to the date on which the investment company's corporate tax return is due, including any extensions of time for filing that may have been obtained, can be deducted from its taxable income for the year to which the return relates (Code, sec. 855(a)) but are taxable to the shareholders in the year in which they receive them (Code, sec. 855(b)).

[8] Code, sec. 243.

[9] Dividends paid by certain foreign corporations and on the preferred stocks of public utilities are exceptions to this rule. Code. secs. 245–247.

[10] Code, sec. 852(b)(3)(A).

[11] Code, sec. 852(b)(3)(B).

[12] Code, sec. 1201(a).

benefit to them. Since the distribution of a capital gain by a corporation usually results in ordinary income to its shareholders,[13] and since capital gains are taxed at appreciably lower rates than those applicable to ordinary income,[14] subchapter M confers substantial additional benefits on investment company shareholders.

Thus, a company that realizes a net long-term capital gain of $1 million and is not a subchapter M company must itself pay a tax of $250,000. When it distributes the remaining $750,000 to its stockholders, they receive ordinary income [15] on which they must pay taxes at the rates generally applicable to such income, which range from 14 percent to 70 percent for individual taxpayers.[16] In contrast, when a subchapter M company realizes a capital gain and proceeds to distribute it to its stockholders, it pays no capital gain tax. And since the stockholders can treat that $1 million as long-term capital gain, not ordinary income,[17] their individual income taxes on their gains may be as low as 7 percent and can never be higher than 25 percent.[18]

2. Undistributed capital gain

A subchapter M investment company has to pay a 25 percent tax on its undistributed capital gains.[19] So do other corporations.[20] Hence with respect to undistributed capital gains $vestment companies have no advantage *as such* over other corporations. But the *stockholders* of subchapter M investment companies do have an advantage over the *stockholders* of other companies. When a company that does not qualify under subchapter M realizes a capital gain which it does not choose to distribute to its stockholders, the stockholders' tax position is unaffected for the time being since they have received nothing from the corporation. But if and when the corporation does pay a dividend derived from its realized capital gain of a previous year, the stockholders realize ordinary income.[21] Hence any realized corporate capital gain that is ultimately distributed to the stockholders is taxed twice: once to the corporation as capital gain and second as ordinary income to the stockholders who receive a dividend derived from that source. Whenever a subchapter M investment company realizes a capital gain which it distributes in some later year, that gain is taxed only once—to the corporation as capital gain. This is so because a subchapter M investment company's undistributed capital gains are deemed to have been distributed to the shareholders during the year in which they were realized by the investment company.[22] This means that the individual stockholder's income for that year is increased by his proportionate share of the investment company's undistributed capital gain.[23] However, the stockholder is entitled to a credit against his tax equal to his proportionate share of the 25 percent

[13] Sec. 316 of the code defines a "dividend" as "any distribution of property made by a corporation to its shareholders * * * out of its earnings and profits." The section does not differentiate profits attributable to long-term capital gains from other profits

[14] Individuals' capital gains are taxed at one-half the rate applicable to ordinary income hut never at a rate higher than 25 percent. Code, sec. 1201(b).

[15] See note 13 on this page.

[16] Code, sec. 1(a)(2).

[17] They can do so even if they have held their shares for less than the six months holding period normally required for long-term capital gain treatment. Compare Code, secs. 852(b)(3)(B) and (C) with Code, sec. 1222(3). Hence a shareholder *can* treat a capital gain dividend as a long-term capital gain even if he received that dividend the day after he purchased the shares that generated it.

[18] Code, sec. 1201(b).

[19] Code, sec. 852(b)(3)(A).

[20] Code, see. 1201(a).

[21] See note 13, supra.

[22] Code, sec. 852(b)(3).

[23] Code, sec. 852(b)(3)(D)(i).

capital gain tax that the investment company has already paid.[24] Since 25 percent is the maximum rate at which capital gains are the stockholder pays no additional taxes on his proportionate share of those gains. In fact, his total income tax payment for the year may be reduced to some extent as a result of the investment company's decision to retain its realized capital gain.[26]

If and when the company distributes such gain in a subsequent year, the distribution is tax free to the stockholder. His share of that gain was already included in his income for a prior year, although it did not increase his out-of-pocket tax liability for that year. Hence it cannot be taxed in a subsequent year.[27]

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[24] Code, sec. 852(b)(3)(D)(ii).

[25] Code, sec. 1201(b).

[26] This is so because most individual taxpayers are taxed at a rate of less than 25 percent on their capital gains. The 25 percent rate affects only those persons whose ordinary income is high enough to subject them to marginal ordinary income tax rates of 50 percent or more. Other taxpayers are taxed on their ordinary capital gains at one-half the rate on which they are taxed on their ordinary income.

For example, if an individual taxpayer in the 30 percent bracket owns shares in a subchapter M investment company that does not distribute its capital gains, his pro rata share of the company's undistributed gains is $100 and he must report a long-term capital gain of $100. Since he will be taxed on that gain at 15 percent (one-half of the 30 percent rate applicable to his ordinary income), his total income tax liability will be $15 higher than it would have been had there been no such undistributed gain. But his pro rata share of the 25 percent gain tax that the investment company has already paid amounts to $25, and he is entitled to credit that $25 against his individual income tax. The taxpayer is therefore entitled to a $10 refund.

[27] For reasons explained in the text and in the preceding footnote, the company's payment of the capital gain tax gives rise to a credit against the individual stockholder's income tax liability except in those cases where his ordinary income tax bracket is 50 percent or higher. A second tax advantage comes into play if the taxpayer sells his shares and if the price that he gets for them reflects the company's retention of the realized capital gain. In that event, the shareholders of subchapter M companies pay a lower capital gain tax than do the shareholders of other corporations. This is so because the corporation's retention of a realized capital gain normally has no effect on the basis of the shareholders' shares while a subchapter M company's retention of a realized capital gain increases the basis of the shareholders' shares by 75 percent of their pro rata shares in such gain. Code, sec. 852(3)(D)(iii).

For example, assume that X buys a share in an investment company for $10. The company then realizes a capital gain equal to $2 per share and retains that gain in its tresaury. X thereafter sells his share for a price that reflects this retention, that is, for $12 per share. If the company is not a subchapter M company X is deemed to have realized and is taxed on a capital gain of $2. But if the company is a subchapter M company, X's basis rose at the time the company realized the gain by $1.50 (75 percent of the $2 undistributed capital gain) from $10 to $11.50. Accordingly when X sells, he is deemed to have realized and is taxed on a gain of only 50 cents.