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VALUATION OF MUTUAL FUND SHARES FOR FEDERAL ESTATE AND GIFT TAX PURPOSES

Mutual funds (open-end diversified investment companies) have recently become one of this country's fastest growing businesses.[1] Their popularity stems from inherent characteristics which make them attractive investment outlets for the general public.[2] By investing in a mutual fund the average individual is able to pool his funds with others so that the capital aggregate is sufficient to retain professional advice. This, of course, increases the likelihood that perspicacious investment practices will be followed.[3] Prior to the mutual funds boom, securities were sold primarily to the relatively wealthy individual who could afford professional investment counsel.[4]

Although there is not an established market for mutual fund shares comparable to the stock exchanges for regular securities, there is enough of a "market" to establish buying and selling procedures. A *"closed-end"* investment company is limited in the number of shares which it may issue. The price of its shares, therefore, is determined by the natural market operations of supply and demand.[5] A mutual fund (*"open-end"* company), on the other hand, is unrestricted in issuing new shares. The fund can issue as many shares as it wishes, so long as there are buyers. Increased demand for a fund's shares does not affect the price, because there is an unlimited supply. Price is based upon a value determination made by adding together the current market values of the fund's investments, deducting the liabilities and dividing by the number of

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[1] Mutual funds attract an increasing number of investors each year. In 1960, the total net assets in 161 mutual funds were approximately $17 billion compared to $15.8 billion in 1959 and $21 billion in 1961. See SECURITIES PUBLISHING DIVISION, COMMODITY RESEARCH PUBLICATIONS CORP., UNDERSTANDING THE MUTUAL FUNDS 1 (1961) (hereinafter cited as SECURITIES PUBLISHING DIVISION); *The Fight on Mutual Fund Fees,* Business Week 110 (Dec. 16, 1961).

[2] One-sixth of all shareholders in American industry own shares of mutual funds. Shareholder accounts average $3,690 and are held by investors ranging from the young, who are building for the future, to institutional investors such as universities and pension funds. See 61 *Fortune* 144 (June 1960).

[3] SECURITIES PUBLISHING DIVISION, *op. cit. supra* note 1, at 2.

[4] *Id.* at 3.

[5] Interview with Lyle Wurtz of First Nebraska Securities, Lincoln, Nebraska, January 25, 1963.

shares outstanding.[6] The result is labeled the *net asset value* per share.[7]

The amount which the purchaser is required to pay for each share is the net asset value *plus* the sales charge of the fund's selling organization, or merely net asset value in those funds which do not charge a sales fee.[8] Sales charges vary from about 0.5% to 9%,[9] and become proportionately smaller as the number of shares purchased by the investor increases.[10] For example, if a small number of shares of a particular fund is purchased, the sales charge or acquisition cost is about 8%. On the other hand, a purchase of a large number of shares in the same fund would require only a 2% sales fee.[11]

If the investor wishes to redeem, he is assured of a ready buyer because the mutual fund itself stands ready to redeem for the net asset value.[12] Some funds charge a redemption fee which is generally from 0.5% to about 1%;[13] however, the majority of

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6 Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181, 183 n.6 (1961).

7 *Ibid.*

8 SECURITIES PUBLISHING DIVISION, *op. cit. supra* note 1, at 11.

9 See Lobell, *supra* note 6, at 182 n.5. "Sales charges or 'loads' vary among funds and, within funds, vary with dollar amounts of shares purchased or committed to be purchased, reduced charges applying to larger single purchases or purchase commitments. Sales charges of 8% to 8½% are common. 6% or more may be paid to retail distributors and the balance kept by the fund's wholesale distributor or 'principal underwriter.' The principal underwriter, who operates under a contract with the fund, bears the entire cost of literature, statistical presentations, and other sales aids provided to investment retailers."

A sample of the varying sales charges within the fund are given below:

Fund	*Large Purchase*	*Small Purchase*
Aberdeen Fund	8.50%	2.50%
Florida Growth Fund	6.50	0.50
Dreyfus Fund	7.50	0.95
International Resources	6.75	2.25
Wall Street Investing	8.50	1.00

See ARTHUR WIESENBERGER & CO., MUTUAL FUNDS PANORAMA (June 30, 1962).

10 See note 9, *supra.*

11 This is the range of sales fees charged by Wellington Fund, one of the larger funds. See ARTHUR WIESENBERGER & CO., MUTUAL FUNDS PANORAMA (June 30, 1962).

12 See Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 YALE L. J. 1258, 1262 n.19 (1961).

13 *Ibid.*

those that do charge such a fee do not charge a sales fee.[14] On any given day one can determine the redemption price and the purchase price of a share by consulting the daily newspapers, which list them as "bid price" and "asked price" respectively. The difference between the two prices represents the sales fee or, as it is commonly called, the acquisition cost.[15]

Another important characteristic of a mutual fund's buying and selling procedure is that there are virtually no transactions between private individuals.[16] The brokers and dealers of mutual fund shares are normally obligated by contract with the fund to refrain from privately transferring shares offered by a seller to a buyer.[17] Since buyers and sellers generally do not come together except through a broker,[18] mutual fund shares, for all practical purposes, change hands privately only as the result of a gift or by inheritance. Therefore, when the owner of a share wishes to sell, he is required to redeem directly from the broker at the listed redemption price.[19] When an investor wishes to purchase fund shares, he must buy from a broker at the listed purchase price.[20] Because of these established and somewhat unique buying and selling procedures, the following discussion is devoted to the problem of valuing mutual fund shares for federal estate and gift tax purposes.

The federal estate tax is computed upon the "value" of the

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[14] ARTHUR WIESENBERGER & CO., MUTUAL FUNDS PANORAMA (June 30, 1962); Interview with Lyle Wurtz of First Nebraska Securities, Lincoln, Nebraska, January 25, 1963.

[15] Wall Street Journal, Feb. 19, 1963, p. 22 cols. 1 and 2. The funds are listed in the following manner:

Fund	*Bid*	*Asked*
Aberdeen Fund	$ 2.15	$ 2.35
Dreyfus Fund	15.99	17.38
Fundamental Investment	9.35	10.35
Wall Street Investment	9.12	9.87

The sales charge of each company accounts for the difference between the two prices. See SECURITIES PUBLISHING DIVISION, *op. cit. supra* note 1, at 11.

[16] Interview with Lyle Wurtz of First Nebraska Securities, Lincoln, Nebraska, January 25, 1963.

[17] *Ibid.*

[18] *Ibid.*

[19] SECURITIES PUBLISHING DIVISION, *op. cit. supra* note 1, at 12.

[20] *Ibid.*

property at the time of death,[21] or at an alternate valuation date.[22] Similarly, the federal gift tax[23] is based upon the "value" of the property at the date of the transfer.[24]

The regulations define value as "fair market value,"[25] and, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."[26] Under regulations proposed in June, 1962 by the Internal Revenue Service, fair market value of a mutual fund share is[27]

> . . . the *replacement cost* for a share on the applicable valuation date as quoted by the company for that date, or if the replacement cost is calculated more than once on that date, then the mean of the highest and lowest such replacement costs . . . .

Generally, where there is an existing market or where actual sales have been made between willing buyers and willing sellers, market price is used.[28] For this reason, market price is determinative of the value of securities;[29] the mean between the highest and

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21 INT. REV. CODE of 1954, § 2031(a) provides: "(a) *General.* The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death. . . ."
INT. REV. CODE of 1954, § 2033, as amended, 76 Stat. 1052 (1962) provides: "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

22 INT. REV. CODE of 1954, § 2032.

23 INT. REV. CODE of 1954, § 2512(a) provides: "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift."

24 These values also have significance in the income tax area. The value stated on the estate tax returns is used as the basis for income tax. INT. REV. CODE of 1954, § 1014. See Brewster v. Gage, 280 U.S. 327 (1930). The amount of gift tax paid may be added to the donor's basis to compute the donee's income tax in some situations. See INT. REV. CODE of 1954, § 1015(d).

25 26 C.F.R. § 20.2031-1(b) (1961): "The value of every item of property includible in a decedent's gross estate . . . is its fair market value. . . ."; 26 C.F.R. § 25.2512-1 (1961): "The value is generally to be determined by ascertaining as a basis the fair market value at the time of the gift of each unit of the property."

26 This same definition of value is used in both the estate tax and gift tax areas. See 26 C.F.R. §§ 20.2031-1(b), 25.2512-1 (1961).

27 Proposed Treas. Reg. §§ 20.2031-2(j), 25.2512-2(g), 27 Fed. Reg. 5268 (1962) (Emphasis added.)

28 Newberry v. Commissioner, 39 B.T.A. 1123 (1939).

29 See Annot., 160 A.L.R. 669 (1945); LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES § 18.12 (2d ed. 1962); Zanuck v. Commissioner, 149 F.2d

lowest quoted selling prices on the date of valuation is theoretically the price at which the securities would have changed hands.[30] The market price is the price which reflects the value of the securities to the *seller*. Evidently, commission charges and other sundry expenses are not considered in establishing value, because they add nothing to the market price. Under the proposed regulations, however, mutual fund shares, which more closely resemble regular securities than any other type of investment, have a fair market value which includes these expenses.

Replacement cost is used for valuing such things as jewelry[31] or life insurance policies,[32] where there is virtually no established market. It apparently is used in these situations because it is the "best evidence"[33] of value, especially where property has been

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714 (9th Cir. 1945), where the taxpayers, husband and wife, made a gift of 30,000 shares of common stock of Twentieth Century-Fox Film Corporation to three children. Taxpayers objected to the use of market price as a criterion of value, because "unusual circumstances," *i.e.*, the war and labor troubles, made uncertain the value of certain holdings and affected the intrinsic worth of the stock. Taxpayers contended that all of these factors should be considered in valuation proceedings. The court said, "[P]rices at which the corporate stock is actually traded on open public market at basic date are generally regarded as most dependable evidence of their value on that date. . . ." See also Clause v. Commissioner, 154 F.2d 655 (3d Cir. 1946); Bull v. Smith, 119 F.2d 490 (2d Cir. 1941).

[30] See 26 C.F.R. §§ 20.2031-2(b), 25.2512-2(b) (1961). "If there is a market for stock and bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond."

[31] Duke v. Commissioner, 200 F.2d 82 (2d Cir. 1952), *cert. denied*, 345 U.S. 906 (1953); Publicker v. Commissioner, 206 F.2d 250 (3d Cir.), *cert. denied*, 346 U.S. 924 (1953).

[32] Guggenheim v. Rasquin, 312 U.S. 254 (1941).

[33] This is the language used in the cases cited in note 31, *supra*. In Guggenheim v. Rasquin, 312 U.S. 254, 257 (1941), the Court said: "Surrender of a policy represents only one of the rights of the insured or beneficiary. Plainly that right is one of the substantial legal incidents of ownership. . . . But the owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy upon the insured's death. That these latter rights are deemed by purchasers of insurance to have substantial value is clear from the difference between the cost of a single-premium policy and its immediate or early cash-surrender value. . . . All of the economic benefits of a policy must be taken into consideration in determining its value for gift-tax purposes. To single out one and to disregard the others is in effect to substitute a different property interest for the one which was

transferred shortly after the purchase.[34] Even in these areas where value is difficult to determine, replacement cost is commonly, but not exclusively, used. Where there is a substantial lapse of time from the date of purchase to the date of transfer, factors such as expert testimony may be considered to determine value.[35] In *Duke v. Commissioner*,[36] where the taxpayer purchased jewelry and gave it to his wife shortly after the purchase, replacement cost was used. In a similar case, *Publicker v. Commissioner*,[37] it was held that replacement cost of large diamonds was properly relied upon to establish value. In *Estate of Gould v. Commissioner*,[38] where the taxpayer made a gift of an expensive ring, the Tax Court said:

> Generally, such a sale is regarded as the best evidence of value of the article involved, *i.e.*, the amount of money which changed hands in the sale and purchase is regarded as the value of the article.[39]

In *Guggenheim v. Rasquin*,[40] where the taxpayer gave a paid-up life insurance policy, the United States Supreme Court said that replacement cost was properly used. It seems, therefore, that replacement cost is used only in those situations where there is no better evidence of value to the donor. If this is true, then surely replacement cost should not be used for valuing a fund share, because the value to the donor (net asset value) is calculated twice each day by the mutual fund.

The mutual fund stands in the dual position of both a willing seller and a willing buyer. There are two prices at which a mutual

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the subject of the gift. . . . Cost is cogent evidence of value. And here it is the only suggested criterion which reflects the value to the owner of the entire bundle of rights in a single-premium policy—the right to retain it as well as the right to surrender it."

[34] See note 33, *supra*. Note that the proposed regulations offer no distinction between valuation for gift tax purposes and valuation for estate tax purposes. Replacement cost is to be used in both situations. Although there is authority to the contrary, it would seem that replacement cost would find more support in the gift tax area where the transfer is made voluntarily than in the estate tax area where property passes involuntarily. LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES § 18.1 (2d ed. 1962).

[35] See Publicker v. Commissioner, 206 F.2d 250 (3d Cir.), *cert. denied*, 346 U.S. 924 (1953).

[36] 200 F.2d 82 (2d Cir. 1952), *cert. denied*, 345 U.S. 906 (1953), *rehearing denied*, 345 U.S. 931 (1953).

[37] 206 F.2d 250 (3d Cir.), *cert. denied*, 346 U.S. 924 (1953).

[38] 14 T.C. 414 (1950).

[39] *Id.* at 416.

[40] 312 U.S. 254 (1941).

fund share would change hands. Either the replacement cost (the price at which the fund as seller would willingly sell) or the net asset price (the price at which the mutual fund would willingly buy) could be used as fair market value according to the willing buyer-willing seller definition of value used in the regulations. The question emerges as to which one of these tests most fairly and accurately establishes the true value of a mutual share.[41]

If the mutual fund is considered as the seller in the definition, then the acquisition cost (sales charges) is included as part of the value. It is questionable to include acquisition cost, because of the mutual fund share's similarity to general securities. It seems that the donor of the property, rather than the mutual fund, should be considered as being in the position of a seller. It is the value of the property to the *donor*, which is being sought. Using the willing buyer-willing seller definition with the donor as the seller, the *only* buyer which the willing seller may find is the mutual fund. Being the *only* buyer, the fund becomes a *willing* buyer only at the net asset value or bid price. Thus, because of the uniqueness of the market for mutual fund shares, net asset value should be determinative of fair market value.

Even if a fictitious private market with ready and able buyers and sellers is assumed, the fair market value must still be something other than replacement cost. The willing buyer would not pay above replacement cost, because he can go directly to the mutual fund's broker and purchase for that price. He can rely upon replacement cost as a ceiling on his purchase price, because of the fact that increased demand on an open-end company's shares does not cause price to increase as it would with ordinary securities. Similarly, a willing seller, who could also go directly to the fund and receive the net asset price, would deal for something above the net asset price. As in the case of over-the-counter securities, the two would theoretically meet halfway between the net asset price and replacement price giving equal economic advantages to both parties.

To further criticize the use of replacement cost, note that the great majority of funds charge a sales fee,[42] and because that sales fee varies with the size of the purchase, the use of replacement cost is unfair. This statement may best be explained by using a hypothetical example. Suppose the net asset price of a mutual fund's

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[41] LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES § 18.14 (2d ed. 1962).

[42] Of the 238 funds examined, 202 charged a sales fee and each had a "varying" sales charge. See note 9, *supra*.

shares is $100 per share at the time Mr. A purchases 1,000 shares. Because of the large initial purchase, Mr. A would have the advantage of buying at the reduced sales fee of perhaps 2%, or $102 per share. Suppose, also, that at this very same time Mr. B purchases only one share. The purchase being small, Mr. B has to pay a sales fee of 8% or $108 per share. Now, suppose both A and B, upon leaving the broker's office, go directly to each of their sons' homes and, as gifts, deliver their purchases to their sons. Following the proposed regulations, the basis upon which Mr. A is taxed is $102 per share, while the basis upon which Mr. B is taxed is $108. The result is that for the very same share, purchased at the same time, and given to a donee on the same day, very different values are attached.

It seems basically unfair to require Mr. B to pay a tax based on higher per share value merely because his purchase was small. This is especially true when one considers the fact that mutual funds are especially adapted to the small investor. It may be true that a situation such as this would sometimes arise when the gift is of ordinary stocks or bonds due to the operation of the blockage rule.[43] In ordinary security valuation, however, the reason for the blockage rule is that the dumping of a large number of shares on the market increases supply beyond demand, thus depressing the market price. The same considerations, however, are not applicable in the area of mutual funds, because (1) there is no market, except for the mutual fund itself, and (2) the net asset value, the price at which the fund redeems, is not affected by the redemption of a large block of fund shares.[44]

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[43] See Avery v. Commissioner, 3 T.C. 963 (1944), where Sewell L. Avery of Montgomery Ward & Co. gave to his daughters a total of 16,000 shares of United Gypsum Co. common stock and 26,000 shares of Montgomery Ward & Co. common stock. The court utilized the blockage rule in determining fair market value for estate and gift tax purposes.

Peters, *The Fair Market Value of Blocks of Stock,* 17 TAXES 17 (1939); Barrett, *Valuation of Stocks by the Blockage Rule,* 29 TAXES 465 (1951). "Blockage is not . . . applied automatically in valuing a large block of securities. The taxpayer must prove by the testimony of expert dealers, stock exchange quotations, and any other relevant statistical data, that the effect of marketing a block of securities of the size being valued . . . would be to depress the market. . . ." LOWNDES & KRAMER, *op. cit. supra* note 1, § 18.26. For cases applying the blockage rule see Bartol v. McGinnes, 185 F. Supp. 659 (E.D. Pa. 1960); Bartram v. Graham, 157 F. Supp. 757 (D. Conn. 1957). For cases rejecting blockage on their facts see Mott v. Commissioner, 139 F.2d 317 (6th Cir. 1943); Union Nat'l Bank v. Driscoll, 32 F. Supp. 661 (W.D. Pa. 1940); Gamble v. Commissioner, 101 F.2d 565 (6th Cir.), *cert. denied,* 306 U.S. 644 (1939).

[44] Lobell, *op. cit. supra,* note 14, at 183 n.6. The net asset value for one

The use of replacement cost as fair market value is also inaccurate. First, suppose Mr. A, after buying his 1,000 shares at $102 per share, gives only one of them to his son. If one follows the proposed regulations the value of the gift for federal gift tax purposes is $108. The taxpayer, as a result of this inaccuracy, is paying a tax on a "fair" market value which is $6 per share higher than the market price actually paid on the day of the gift. Second, suppose that Mr. B's purchase was the one-thousandth such purchase by Mr. B, and upon leaving the broker's office, he suffers a heart attack and dies immediately. His son inherits the bundle of 1,000 shares. Even though Mr. B paid $108 per share, the proposed regulations would place the value at $102 per share, or $6 less than was actually paid.

In any case in which regulations are criticized as being unfair and inaccurate, an attempt should be made to propose another method which more accurately and fairly establishes value.[45] From the foregoing analysis, two methods of valuation seem more closely related to fair market value than that suggested in the proposed regulations. They are (1) the net asset price (bid price), and (2) the mean between the net asset price and the replacement cost (asked price). Of these two, the latter method requires the unrealistic assumption of buying and selling between private individuals. For that reason it seems that the preferable method would be to use the net asset value, which is realistic, and more readily effectuates the intent of the estate and gift tax valuation statutes.

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share is the same as the net asset value for each share in a block of several shares. For example, insert into the formula for figuring net asset value the following figures: (1) current market value of fund's investments=$1,000,000; (2) liabilities=$10,000; and (3) number of shares outstanding=100,000 shares. Net asset value per share is $9.90. Now suppose that exactly one-half the shares are redeemed. The mutual fund will, theroretically, have to reduce its investments by one-half; liabilities will decrease because of the smaller volume of business. Net asset value per share remains virtually the same even after an exceedingly large number of shares are redeemed. In fact, the redemption of a large number of shares may cause the net asset value to rise, because the fund may not have to reduce its investments in securities by exactly one-half to meet redemption demands. If it does not, the net asset value will increase, because total investments are divided by a smaller number of outstanding shares.

In order for the redemption of mutual fund shares to depress net asset value the number would have to be so large that the fund would have to reduce the major portion of its holdings, thus destroying saleability of the funds shares.

[45] LOWNDES & KRAMER, *op. cit. supra* note 8, § 18.14.