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RQ-901

Texas House of Representatives
Committee on Pensions & Investments

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Honorable Dan Morales
Attorney General of Texas
Opinion Committee Division
P.O. Box 12458, Capitol Station
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Opinion Committee

RE: *Would a provision in a trust instrument governed by the Texas Trust Code — specifically, a pooled income fund — fundamentally depart from Texas law if it authorized the distribution of short term capital gains received as part of mutual fund dividends to the income beneficiaries of the trust?*

Dear General Morales:

I. Introduction to Pooled Income Funds.

Charitable pooled income funds are given favorable tax treatment by the federal government because of their benefits to charities. Internal Revenue Code ("IRC") § 642(c)(5) governs the requirements for a trust to qualify as a pooled income fund. They are especially convenient for use by donors of relatively small sums, who can gain the advantage of professional management at low costs by pooling contributions with other, like contributors. Under the terms of the trust agreement which establishes the pooled income fund, a donor pledges assets to charity, but the charity does not receive the income until the donor's death. During the donor's lifetime, the donor retains an income interest in the assets. The funds from each donor are pooled and invested with other like donations, but accounted for separately. Such a "pooled" arrangement makes giving assets to charity more affordable, since a separate trust is not needed for each donor. The donor receives the income for the period designated in the donative transfer and, upon the donor's death (or any other terminating event established by the donor), the principal is distributed to charity, as directed by the donor.

II. The Income Distribution Requirement.

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The attraction of a charitable pooled income fund is determined, in large part, by its ability to deliver a return to the donor, as income beneficiary. The fund is required to return income to the income beneficiaries. Often smaller pooled income funds invest their assets in mutual funds rather than bear the costs associated with setting up a separate portfolio of stocks and bonds. The manager of the mutual fund is more easily and cheaply able to invest the larger sum of money. With respect to the mutual funds in which the pooled income fund invests, mutual fund distributions are paid from two sources for income tax purposes:

- (1) Investment company taxable income (net investment income plus net short term capital gains) - designated as "dividend" distributions; and*
- (2) Long term capital gains (net long-term capital gains minus net short term capital losses) designated as "long-term capital gain" distributions.*

A mutual fund, as a regulated investment company, essentially is required to distribute to its investors 90% of the dividends described in (1) above in order to avoid tax at the entity level. These distributions include short term capital gains realized by the mutual fund. The distributions to investors in the mutual fund are taxed and reported by the investors as dividend income. The mutual fund reports the distributions to the investors on Form 1099-DIV in the same manner that a corporation would report a dividend. The investor is taxed on the short term capital gain dividend received as dividend income, which is included in ordinary income for income tax purposes on the investor's income tax return. Thus, from an income tax perspective, short term capital gains from mutual funds clearly are included as income. The investor can not use the short term capital gain from mutual fund distributions to offset the investor's short term capital losses.

The investor in the mutual fund under the scenario described above is the pooled income fund itself, which has banded with like funds to achieve economies of scale by investing in mutual funds. While the pooled income fund, as the mutual fund investor, will receive short term capital gains as part of the distribution of income by the mutual fund to the pooled income fund, it is not clear if the pooled income fund can pass on to its donors (i.e., the income beneficiaries) the short term capital gains it received from the mutual funds in which it has invested. Texas has yet to determine if a charitable pooled income fund can distribute short term capital gain mutual fund dividends ("ST Dividends") to the income beneficiaries of the pooled income fund when the trust instrument is silent with regard to such distributions. Where the trust instrument specifically authorizes the trust to distribute short term capital gains dividends from mutual funds to the income beneficiary, that direction will be honored. § 113.101(a)(1). The question is whether or not such a provision fundamentally departs from Texas law.

III. ST Dividends Should be Distributable to Income Beneficiaries.

Pooled income funds are governed by both state and federal laws. For a pooled income fund to take advantage of the opportunity allowed by federal tax standards, it must be

consistent with Rev. Proc. 88-53, follow the terms of the trust agreement, and be valid under local law. Revenue Procedure 88-53 provides that:

The operation of the fund shall be governed by the laws of the State of _____. However, the trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the qualifications of the fund under Section 642(c)(5) of the Code and corresponding regulations.

IRC § 642(c)(5) sets out the procedure for donating and accepting property into a pooled income fund. The section reiterates that the trust must abide by local laws. See also, Private Letter Ruling 9402020 (income of pooled income fund is determined under the terms of the governing instrument and local law). If a trust is seen as fundamentally departing from local laws, then it will not be afforded its favorable federal tax status. Treas. Reg. § 1.643(b)-1. Therefore, it is very important that distribution of ST Dividends to the income beneficiaries of the pooled income fund as directed by the trust agreement not depart fundamentally from the law of the State of Texas.

The IRS has previously determined that a pooled income fund that distributes net short term capital gains to the income beneficiaries, in accordance with a trust agreement so providing, continues to qualify as a pooled income fund under IRC § 642(c)(5). Private Letter Ruling 8404039. Although Private Letter Rulings are not binding on the IRS, they usually are good indicators of the IRS' position. Thus, Private Letter Ruling 8404039 indicates that if a trust agreement governing a pooled income fund allows distribution of short term capital gains as income, the IRS will find that the pooled income fund continues to qualify for the favorable tax treatment given to pooled income funds under IRC § 642(c)(5).

For the question at issue, the key local laws are the Texas Trust Code. The Texas Trust Code provides that in the first instance, income is to be determined by the instrument establishing the trust. Texas Trust Code § 113.101(a)(1). If it is assumed that the trust instrument governing the pooled income fund directs that ST Dividends are to be distributed to the income beneficiaries of the pooled income fund, Texas law would respect this direction. See § 113.101(a)(1). That would appear to be the fundamental state public policy. What the Texas Trust Code would allow if the trust instrument were silent -- e.g., § 113.104(c)(3) -- is merely a fall-back or default position in the event the trust instrument were silent on the point. And while § 113.104(c)(3) may be read as allowing the distribution of ST Dividends to the income beneficiaries when the trust instrument is silent on the point, that issue need not be addressed since, whatever § 113.104(c)(3) says, it does not represent the fundamental policy of the state. The fundamental policy is that the trust instrument governs, except in those cases such as certain aspects of the trustee's duties of loyalty and care (Tex. Trust Code § 113.059(b)) and spendthrift provisions as applied to grantors (Tex. Trust Code § 112.035(d)), where the Trust Code provision cannot be overridden by express trust provisions.

Whether ST Dividends may be distributed to the income beneficiaries of a pooled income fund is of major concern to the trustees and beneficiaries of trusts. Permitting ST

Dividends to be distributed as income, where the trust instrument allows such distributions, will have a positive impact on the effective yield of such trusts. The managers of these funds would view Texas as a more favorable state in which to manage these large sums of money. This issue also affects charities and the Internal Revenue Service. All of the parties would be better served by a clarification of Texas law.

Your opinion is requested on the following question:

- 1. Is it a fundamental departure from Texas law to distribute the short term capital gain component of mutual fund dividends income to the income beneficiaries of a trust, assuming the trust agreement governing the trust so provides?*

Thank you for your attention and assistance in resolving this question. As soon as this request has been assigned, I would appreciate your contacting Sherry Walker at 463-2054 in my committee office.

Sincerely,


Barry B. Telford
Chairman