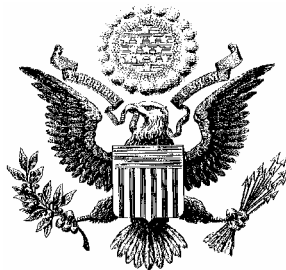


# **PROVIDING TAX EQUITY FOR MUTUAL FUND INVESTORS: CHANGING THE TAX TREATMENT OF CAPITAL GAIN DISTRIBUTIONS**



**Vice Chairman Jim Saxton (R-NJ)**  
**Joint Economic Committee**  
**United States Congress**  
**April 2004**

## **Abstract**

Mutual funds are an important vehicle for low- and middle-income households to invest in the stock market and save for the future. The number of families investing in mutual funds has increased more than 1,000 percent, from 4.6 million households investing in mutual funds in 1980, to a high of 56.3 million in 2001. For 2003, 53.3 million households owned mutual funds.

Recently, the mutual fund industry has received much attention relating to corporate structures, trading fees and expenses, and potential abuses in the industry. All of these issues are important and result in additional costs to mutual fund investors and should be fully addressed. Nonetheless, it is extremely important that attention not be diverted from the largest costs affecting mutual fund shareholders – taxes.

Even if shareholders do nothing more than buy and hold mutual fund shares, they could still be hit with potentially large tax liabilities due to capital gain distributions. Shareholders are then either forced to sell assets to pay the tax liability, or must divert capital from other more productive uses in order to pay the tax. The current tax on mutual fund capital gain distributions is economically inefficient, creates an opportunity cost to shareholders, and can further result in considerable economic losses due to the effects of compounding.

A bill (H.R. 496) introduced by Rep. Jim Saxton (R-NJ) addresses the problems taxable mutual fund investors face relating to the unfair and highly punitive tax levied on capital gain distributions. The bill would allow a deferral of capital gain distributions up to \$6,000 for married couples filing jointly and \$3,000 for all other tax filers. The deferral provision in Rep. Saxton's bill would provide substantial benefits to low- and middle-income taxpayers investing in mutual funds and significantly aid American families saving for their future.

# PROVIDING TAX EQUITY FOR MUTUAL FUND INVESTORS: CHANGING THE TAXATION OF CAPITAL GAIN DISTRIBUTIONS

Taxes can be the most significant cost of investing in a mutual fund.

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## I. INTRODUCTION

Mutual funds are an important vehicle for low- and middle-income households to invest in the stock market and save for the future. Mutual funds pool investment money from numerous shareholders and invest in a diversified portfolio of securities to minimize risk and maximize returns. Over the past two decades, the number of families investing in mutual funds has increased more than 1,000 percent, from 4.6 million households investing in mutual funds in 1980, to a high of 56.3 million in 2001. For 2003, 53.3 million households owned mutual funds. For many families, mutual funds are a primary savings vehicle for retirement. However, mutual funds have one major drawback: the annual taxation of capital gains distributed by the mutual fund to its shareholders.

In a number of respects, the current tax system is counterproductive and biased against saving and investment. The tax system imposes large losses on the economy that reduce the economic welfare of households. The current levels of taxation can impose relatively high output and welfare costs on the economy. While the range of economic losses imposed by the current level of taxation is rather broad, a conservative estimate is that these excess marginal burdens range from 25 to 40 cents of the last dollars raised in federal revenue; other estimates range much higher.<sup>2</sup> The tax treatment of mutual fund investors can be even more punitive.

Mutual fund investors fall into two basic categories: those who pay taxes annually on the distributions of fund dividends and capital gains, and those that hold their shares in qualified tax-advantaged retirement plans (such as IRAs and 401(k)s). Assets held in qualified retirement accounts offer tax-deferred benefits on reinvested dividends and capital gain distributions and asset accumulation. But for shareholders holding mutual fund shares outside of qualified retirement accounts, the annual tax bite levied on their annual distributions can significantly reduce fund performance.

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<sup>1</sup> U.S. Securities and Exchange Commission, Press Release, January 19, 2001, Available on-line at: <http://www.sec.gov/news/mfaffert.htm> or <http://www.sec.gov/news/press/2001-16.txt>

<sup>2</sup> For more information, see United States Congress, Joint Economic Committee, *Tax Reduction and the Economy*. April 1999.

According to a study by KPMG Peat Marwick LLP, before the recently enacted lower tax rates for dividends and capital gains became effective, taxes due on the annual distributions made by mutual funds decreased the performance of a mutual fund by up to 61 percent, or 7.7 percentage points a year.<sup>3</sup> The median loss due to taxes was 16.5 percent or 2.5 percentage points per year.<sup>4</sup> For a \$10,000 initial investment over a ten-year period, a 2.5 percentage point reduction in the performance on a mutual fund earning an annual pre-tax return of 10 percent would amount to a loss of over \$5,000. The loss would be almost \$25,000 over twenty years and \$87,000 over 30 years.<sup>5</sup>

This paper addresses the tax treatment of mutual funds and implications to the taxable mutual fund investor. Section II of this paper addresses the circumstances that lead mutual fund investors to face tax liabilities on their mutual fund investments, even if investors choose not to sell any shares. Section III addresses how the current tax treatment of mutual fund investors is unfair and punitive. Section IV of this study highlights some demographic statistics to illustrate the importance of mutual funds as an investment vehicle for millions of American families. Section V addresses policy considerations to restore the fair tax treatment of mutual fund investors.

## II. TAXING MUTUAL FUND INVESTORS

Taxation of capital gains has been part of the U.S. tax system since the ratification of the 16<sup>th</sup> Amendment to the Constitution in 1913, which allowed for the taxation of individual income. Since that time, there has been debate various issues concerning if, how, and when capital gains should be taxed. One such debate has focused on the realization of capital gains.<sup>6</sup>

Realization of capital gains is the point in time at which ownership rights to appreciated capital assets are exchanged for money. Although many economists argue that capital gains should not be taxed at all, some economists argue a completely opposite position and suggest that capital gain taxes should be levied not only on realized capital gains, but on *unrealized* capital gains as well. Unrealized capital gains are the increases in the value of capital assets, for example stock prices that are not sold for cash but are retained.

Throughout the course of a mutual fund's normal operations, fund managers buy and sell securities attempting to maximize returns to shareholders. In order to eliminate corporate income tax liability on the gains earned from the sale of securities, mutual funds must distribute to their shareholders all of their ordinary income and net capital gains. The gains mutual funds distribute to individual shareholders are subject to capital gains taxation on the individual's

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<sup>3</sup> KPMG Peat Marwick LLP, *Tax-Managed Mutual Funds and the Taxable Investor - 2000 Edition*, pages 18 and 19.

<sup>4</sup> *Ibid.*

<sup>5</sup> Amounts are calculated on a pre-liquidation basis.

<sup>6</sup> For information relating to the historical treatment surrounding the current rationale for taxing mutual fund capital gain distributions, see, United States Congress, Joint Economic Committee, *Encouraging Personal Saving and Investment: Changing the Tax Treatment of Unrealized Capital Gains*, June 2000. Available online at: <http://www.house.gov/jec/tax/mutual/mutual.pdf>

federal and state tax returns. Any undistributed profits of the mutual fund are taxed at the corporate rate.

Even if individual shareholders do nothing more than buy and hold mutual fund shares, they could still be hit with potentially large tax liabilities due to the distribution of gains from their mutual funds. Shareholders are then either forced to sell assets to pay the tax liability, or must divert capital from other more productive uses in order to pay the tax. This is economically inefficient and creates an opportunity cost to the shareholder and can result in considerable economic losses due to compounding.

Although direct owners of stocks pay taxes on dividends received, they do not have to pay taxes on the appreciation of their securities until they sell their shares and actually realize a gain. For direct ownership of stocks, the realization point that triggers a tax liability is the selling of securities by the individual owner. In the case of mutual funds, an additional realization point that triggers a tax liability for shareholders is the selling of securities by the mutual fund, generating taxes on unrealized gains at the individual level. This treatment violates the economic principle of horizontal equity.

Direct owners of stocks are allowed to defer taxation on the appreciated value of their stock shares, while mutual fund shareholders may be forced to pay taxes yearly even if they do not sell (i.e., redeem) any of their mutual fund shares. The current tax treatment of mutual funds is an unfair economic disadvantage to many low- and middle-income households who invest in mutual funds because they usually cannot afford the relatively large amounts of capital necessary to build their own diversified portfolio of stocks. The policy of taxing forced distributions of capital gains to mutual fund shareholders unfairly discriminates against taxpayers seeking the investment benefits of diversification through mutual funds instead of through direct ownership of stocks.

In order to treat mutual fund shareholders and direct stock owners more equally, taxpayers investing in mutual funds outside of individual retirement accounts should be allowed a tax deferral on forced capital gain distributions. In essence, this would provide a rollover treatment of these unrealized capital gains.<sup>7</sup>

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<sup>7</sup> For an example on how the current tax treatment of *unrealized capital gains* unfairly treats mutual fund owners and for an example on how the current tax on capital gain distributions affects the after-tax performance of mutual funds, see, United States Congress, Joint Economic Committee, *The Taxation of Mutual Fund Investors: Performance, Saving and Investment*, April 2001. Available online at: <http://www.house.gov/jec/tax/mutual/mutual2.pdf>

### III. ECONOMIC CONSIDERATIONS

American mutual fund shareholders are often unaware of the tax that they will owe on a fund's capital gain distributions before the distributions are received. The importance of forced distribution of capital gains by mutual funds is evidenced by the extensive media coverage advising shareholders of mutual funds about the economic consequences.<sup>8</sup>

*BusinessWeek* ran a special report titled "Mutual Funds: What's Wrong," that highlighted some of the economic consequences of forced distributions. According to the report, "gains are triggered when managers take profits – a process over which the fund shareholder has no control. Over the past five years, taxes have effectively cost fund shareholders about 2.3 percentage points a year..."<sup>9</sup> Further, a study by KPMG finds that the effective cost of taxation actually has a median value of 2.5 percentage points a year.<sup>10</sup> Another article states, "it's common for a stock fund's after-tax return to be 15 percent to 20 percent less than its pretax return."<sup>11</sup>

As addressed in the introduction, for a shareholder portfolio that starts out with \$10,000 in the first year and returns 10 percent a year before liquidation, an annual 2.5 percentage point reduction in pre-liquidation return would amount to \$5,327 over 10 years, \$24,796 over 20 years and \$86,944 over 30 years. According to the Investment Company Institute, the median value of stock mutual funds held outside of employer-sponsored retirement plans in 2002 was \$30,000.<sup>12</sup> Assuming the same 10 percent rate of return, the same annual 2.5 percentage point reduction would amount to \$15,981 over 10 years, \$74,389 over 20 years and \$260,833 over 30 years.

Another problem created by the taxation of mutual fund capital gain distributions is the calculation of costs basis for tax purposes.<sup>13</sup> The average cost basis must include reinvested dividends and capital gains -- the same dividends and capital gains on which mutual fund owners have already paid taxes. Although many mutual fund companies now calculate the average cost basis for their shareholders, the failure of some taxpayers to account for reinvested dividends and capital gains could result in some taxpayers paying tax twice on the same reinvested dividends and capital gains.

Changing the tax treatment of mutual funds to allow the realization point that triggers a capital gains tax liability to be moved from the mutual fund level to the shareholder level would increase

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<sup>8</sup> See, for example, Sandra Block, "Know the Tax Burden of Funds," *USA Today*, November 14, 2000; Anne Tergersen, "Don't Let the Taxman Eat Your Lunch," *BusinessWeek*, October 23, 2000; and Karen Damato and Ken Brown, "Capital-Gains Payouts Bring Early Taxing Headache to Investors," *The Wall Street Journal*, August 25, 2000.

<sup>9</sup> Jeffrey Laderman and Amy Barrett, "Mutual Funds: What's Wrong," *BusinessWeek*, January 24, 2000, page 72.

<sup>10</sup> KPMG Peat Marwick LLP, *Tax-Managed Mutual Funds and the Taxable Investor - 2000 Edition*, pages 18 and 19.

<sup>11</sup> Leonard Wiener, "The Best-Laid Tax Plans Can Falter When Gains Soar," *U.S. News & World Report*, January 24, 2000, page 68.

<sup>12</sup> Investment Company Institute and the Securities Industry Association, "Equity Ownership in America," Washington, DC: Fall 2002, page 97.

<sup>13</sup> See, Kathy Jones, "Easy Pickin's," *Kiplinger's*, February 2000, pages 84-87.

the rate of return to shareholders and relieve millions of shareholders of the burdensome necessity of accounting for reinvested capital gain distributions. A change in tax treatment would also relieve part of the potential burden on the average American family of being taxed twice on the same gains.

## IV. DEMOGRAPHIC HIGHLIGHTS

Almost 91 million individuals, comprising over 53 million households (or 47.9% of all U.S. households), owned mutual funds as of July 2003 (Chart 1).<sup>14</sup> More than 80 percent of all households that owned mutual funds have some assets in employer-sponsored defined contribution retirement plans and 60 percent have Individual Retirement Accounts.<sup>15</sup> Mutual fund assets held outside of retirement accounts represented 67 percent, or approximately \$4.3 trillion of the total \$6.4 trillion in mutual fund assets at the end of 2002.<sup>16</sup> Based on IRS data, 9.7 million tax returns were filed in 2001 (the most recent data available) that claimed capital gain distributions, down significantly from the 16.1 million tax returns in 1998.<sup>17</sup> The amount reported also declined, to \$12.3 billion in 2001 from \$46.1 billion in 1998 (1998 data were the most recent when the JEC last issued a study on this issue).<sup>18</sup> The 9.7 million tax returns represent approximately 15 million shareholders, down from approximately 25 million shareholders in 1998.

According to the Investment Company Institute (ICI), as of 2003, 77 percent of households that owned shares in mutual funds had an annual household income under \$100,000 (Chart 2). Moreover, 30 percent of households that own mutual funds have an annual household income less than \$50,000.<sup>19</sup>

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<sup>14</sup> Investment Company Institute, *Fundamentals: Investment Company Institute Research In Brief*, Vol. 12, No. 4. Washington, DC: October 2003.

<sup>15</sup> Investment Company Institute, *Mutual Fund Fact Book – 2003*, Washington, DC: 2003, page 44.

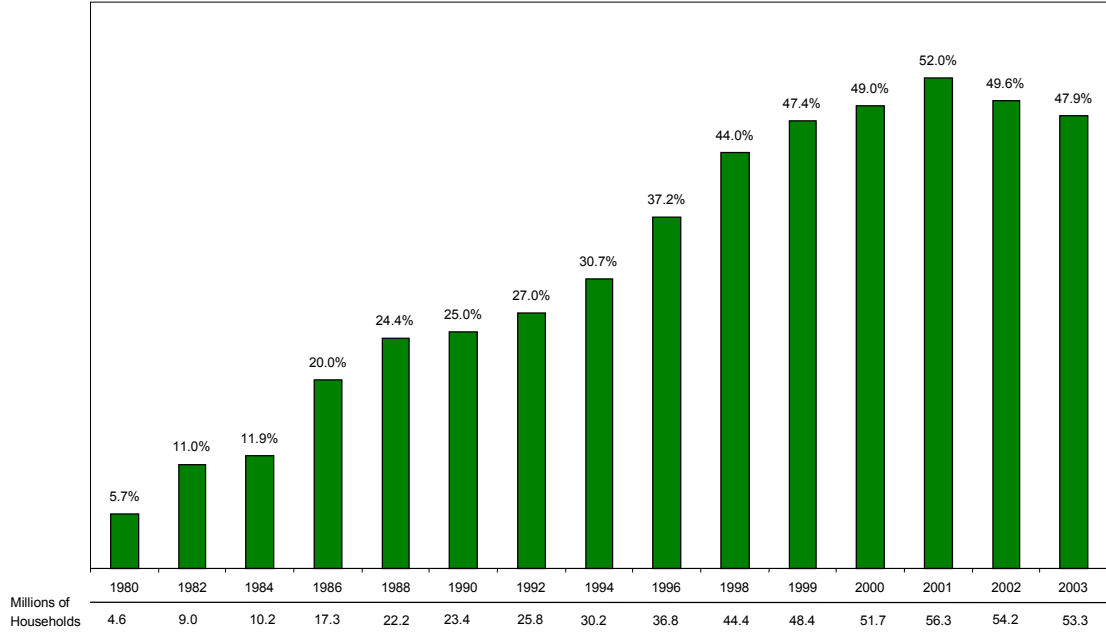
<sup>16</sup> *Ibid.*, pages 48 and 64.

<sup>17</sup> Internal Revenue Service, *Statistics of Income Bulletin*, Washington, DC: Fall 2000 and Fall 2003.

<sup>18</sup> U.S. Congress, Joint Economic Committee, “The Taxation of Mutual Fund Investors: Performance, Saving and Investment,” April 2001.

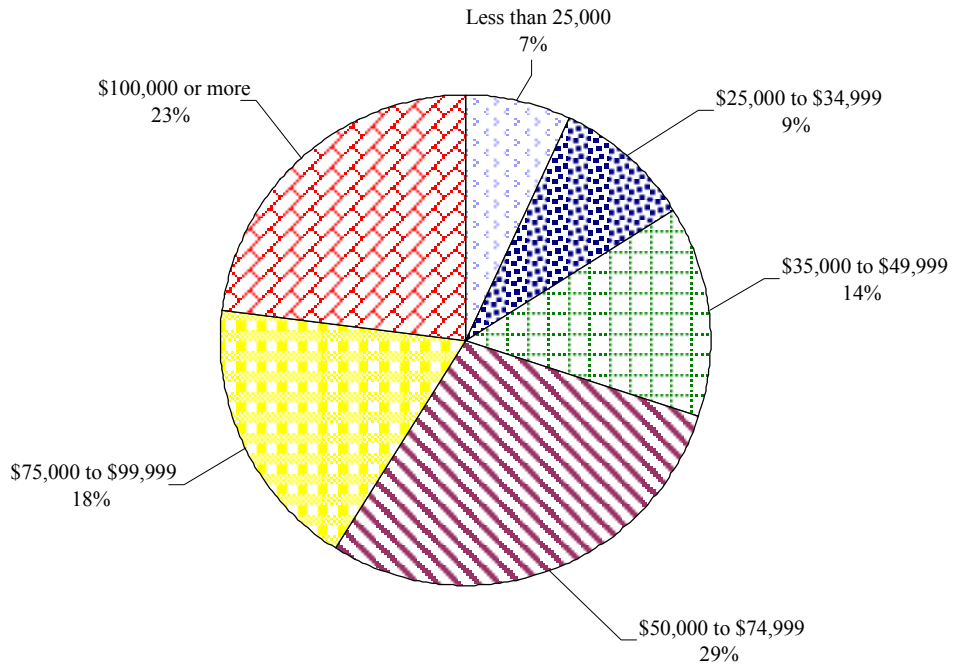
<sup>19</sup> Investment Company Institute, *Fundamentals: Investment Company Institute Research In Brief*, Vol. 12, No. 4. Washington, DC: October 2003.

**Chart 1 - U.S. Households Owning Mutual Funds, 1980-2003, Selected Years**  
(percent and number of U.S. households)



Source: Investment Company Institute, "Fundamentals," October 2003.

**Chart 2 - Percentage of Households Owning Mutual Funds in 2003 by Income**



Source: Investment Company Institute, "Fundamentals," October 2003

Furthermore, as Table 1 illustrates, a significant percentage of U.S. middle-income households own mutual funds. For 2003, 41 percent of households with income between \$35,000 and \$49,999 own mutual funds; 59 percent of households with income between \$50,000 and \$74,999; and 77 percent of households with income between \$75,000 and \$99,999. Mutual funds are even an important vehicle for those households with more modest incomes, with 33 percent of all households with income between \$25,000 and \$34,999 owning mutual funds. Therefore, a change in the tax treatment of mutual funds as discussed in this paper would have a beneficial impact on all owners of mutual funds, but the benefits would primarily help those making less than \$100,000 a year save for their future.

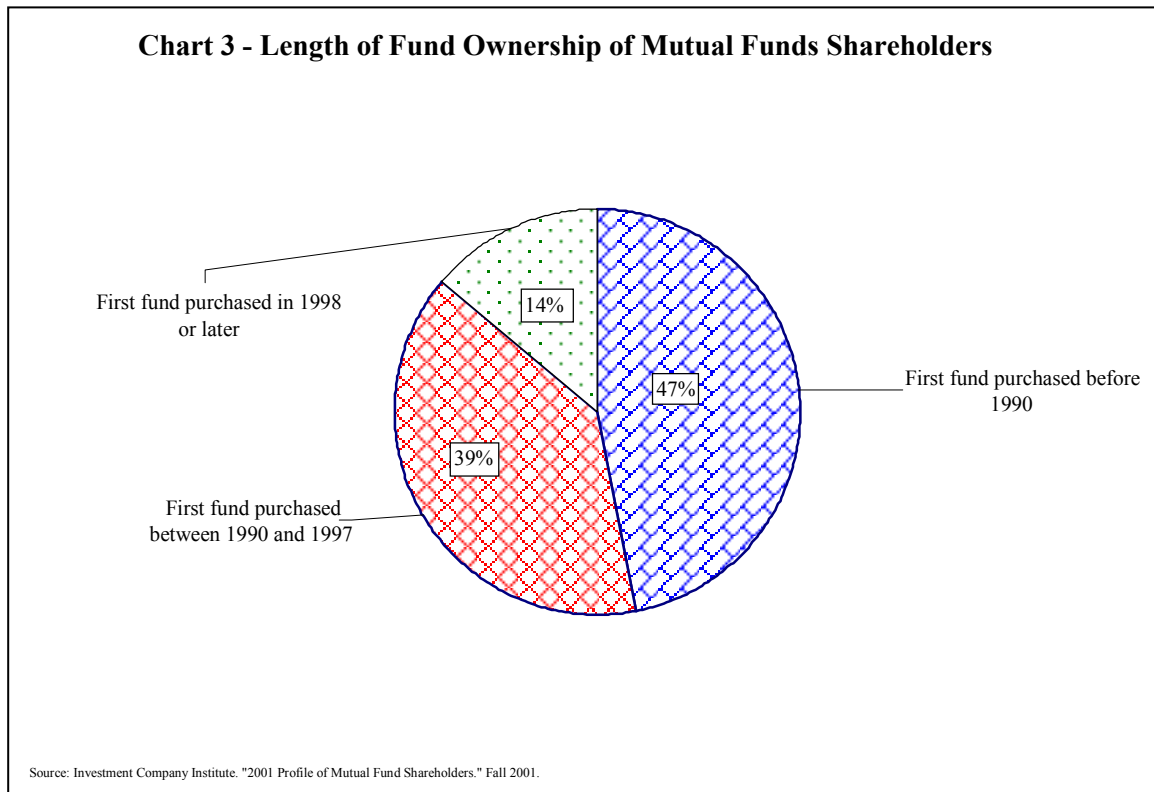
<b>Income Level</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
Less than \$25,000	13%	15%	17%	21%	14%	15%
\$25,000 to \$34,999	28%	30%	37%	38%	36%	33%
\$35,000 to \$49,999	47%	49%	49%	49%	48%	41%
\$50,000 to \$74,999	62%	62%	66%	66%	67%	59%
\$75,000 to \$99,999	72%	78%	77%	78%	79%	77%
\$100,000 or more	77%	78%	79%	85%	82%	83%
Less than \$50,000 (net)	27%	29%	32%	35%	30%	28%
\$50,000 or more (net)	68%	70%	72%	74%	74%	70%

Source: Investment Company Institute. "Fundamentals." October, 2003.  
 Note: Income ranges based upon previous year's pretax household income; differences between 2003 & 2003 are not statistically significant.

Additional survey data from the Investment Company Institute, and summarized in Chart 3, show that 86 percent of all mutual fund shareholders bought their first mutual fund before 1998. Further, just under half entered the mutual fund market before 1990.<sup>20</sup> These facts imply that investors of mutual funds primarily are saving for the future, not engaging in day-trading behavior or other activities with a short-term focus. In fact, of fund owners that purchased their first fund before 1998, 73 percent indicated that their primary financial goal for mutual fund investments was to save for retirement. This figure is 67 percent for fund owners who purchased their first fund in 1998 or later.<sup>21</sup>

<sup>20</sup> Investment Company Institute, "2001 Profile of Mutual Fund Shareholders," Washington, DC: Fall 2001, Figure 32, page 49.

<sup>21</sup> *Ibid.*, Figure 35, page 53.



As shown in Table 2, the number of shareholder accounts has steadily continued to rise, reaching just shy of 251 million accounts in 2002.<sup>22</sup> Also, the amount of assets held in mutual funds has increased dramatically over the past two decades. Mutual fund assets increased at a 23 percent annual rate during the 1990s, growing from \$1.1 trillion in 1990 to \$6.8 trillion by the end of 1999.<sup>23</sup> Total assets leveled off in 2000 and 2001, declining slightly in 2002 to \$6.4 trillion. A first look at the 2003 data released in late March 2004 indicates that mutual fund assets rose by \$1 trillion to \$7.4 trillion.<sup>24</sup>

<sup>22</sup> Investment Company Institute, "Mutual Fund Fact Book 2003," May 2003.

<sup>23</sup> Investment Company Institute, *Perspective*, vol. 6, no. 3, July 2000; *Perspective*, vol. 9, no. 1, February 2003; and "Mutual Fund Fact Book 2003," May 2003.

<sup>24</sup> Investment Company Institute, *Perspective*, vol. 10, no. 1, March 2004.

<b>Table 2 - Total Industry Net Assets, Number of Funds, and Shareholder Accounts</b>			
<b>Year</b>	<b>Total Net Assets (millions)</b>	<b>Number of Funds</b>	<b>Number of Shareholder Accounts</b>
1984	\$370,680	1,243	27,635,660
1985	\$495,385	1,528	34,098,401
1986	\$715,668	1,835	45,373,627
1987	\$769,172	2,312	53,717,241
1988	\$809,371	2,737	54,056,016
1989	\$980,671	2,935	57,559,770
1990	\$1,065,190	3,079	61,947,955
1991	\$1,393,185	3,403	68,331,800
1992	\$1,642,537	3,824	79,931,440
1993	\$2,069,963	4,534	93,213,698
1994	\$2,155,325	5,325	114,383,364
1995	\$2,811,292	5,725	131,219,221
1996	\$3,525,801	6,248	150,042,149
1997	\$4,468,201	6,684	170,264,389
1998	\$5,525,209	7,314	194,073,595
1999	\$6,846,339	7,791	226,412,794
2000	\$6,964,667	8,155	244,748,546
2001	\$6,974,975	8,307	248,759,332
2002	\$6,391,571	8,256	250,981,045

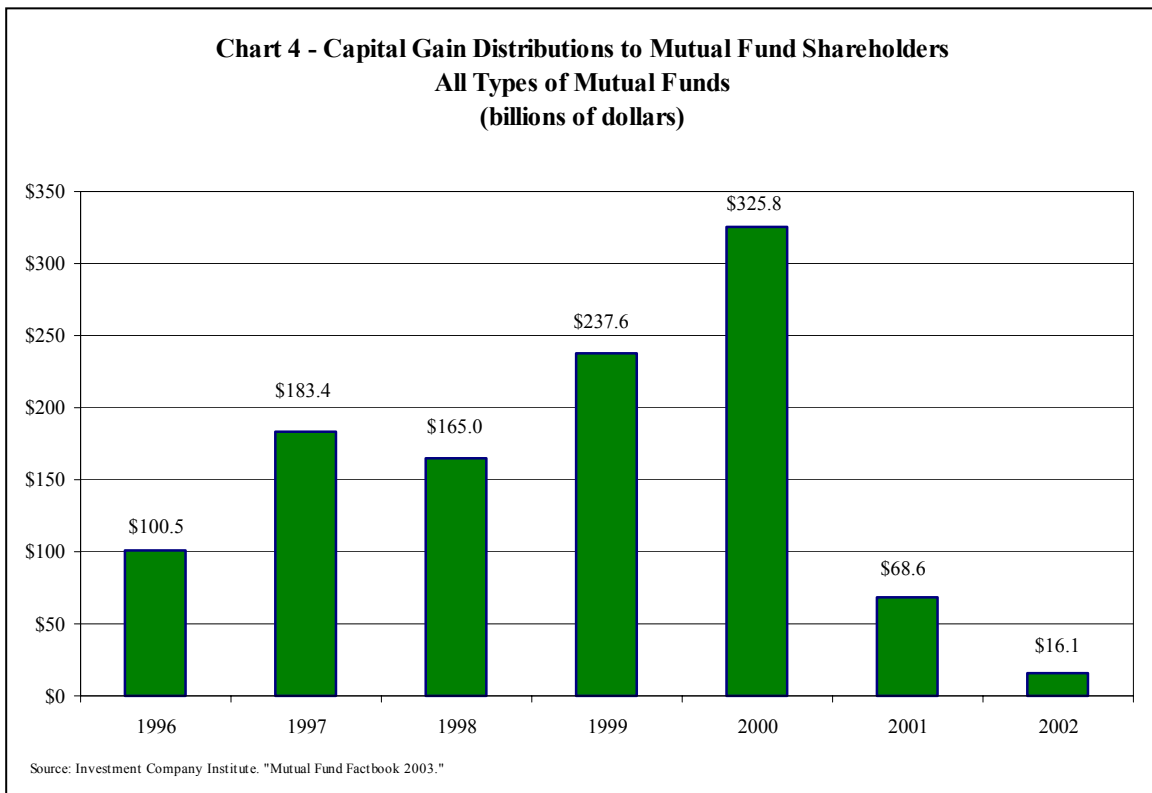
Source: Investment Company Institute. "Mutual Fund Factbook 2003." May 2003.

As the assets of mutual funds have increased, so has the amount of capital gain distributions that have been distributed to shareholders, as displayed in Chart 4 and Table 3. Rising from the 1990 level of \$8.0 billion, capital gains distributions jumped to a record high of \$325.8 billion in 2000 before falling to \$16.1 in 2002.<sup>25</sup>

As the equity markets grew to record highs in the 1990s, the amount of undistributed capital gains stored in mutual funds grew as well. The high amount of undistributed capital gains meant a high tax bill to fund shareholders when fund managers decided to sell the underlying assets. After the bursting of the stock market bubble in early 2000, fund managers were under pressure to minimize increasing losses and boost fund returns. In order to achieve better returns, fund managers sold off many underlying equities that had accumulated large amounts of unrealized capital gains. The resulting sales by fund managers led to hefty mutual fund capital gain distributions in 1999 and 2000.<sup>26</sup> The dramatic pre-2001 increase in the dollar amount of forced capital gain distributions caused the average American family to be hit with a sizeable tax liability, even if they did not sell shares in their mutual fund.

<sup>25</sup> Investment Company Institute, "Mutual Fund Fact Book 2003," May 2003.

<sup>26</sup> Investment Company Institute. "Mutual Fund Fact Book 2003," May 2003 and *Perspective*, February 2003.



As shown in Table 3, the rise in capital gain distributions correlates with a rise in the amount of undistributed capital gains held in equity funds. After the steep decline in the equity markets starting in 2000, and the negative returns that followed, equity mutual funds exhibited *negative* undistributed capital gains. In essence, these are losses that can be carried forward to future years.

The capital losses can be applied to future capital gains, hopefully minimizing the amount of future capital gain distributions and providing fund shareholders some tax relief from the unfair tax consequences of capital gain distributions for a brief time. However, unless legislative action is taken soon, as the markets recover and continue to grow mutual fund capital gain distributions will inevitably increase and cause an unwelcome and unfair tax burden on mutual fund shareholders, as has been the case previously.

Table 3 - Capital Gain Distributions and Undistributed Equity Fund Capital Gain as a Percentage of Equity Fund Assets					
Year	Distribution - All Funds (billions)	Distributions - Equity Funds (billions)	Undistributed Capital Gain - Equity Funds (percent of assets) <sup>1</sup>	Net Assets - Equity Funds (billions)	Undistributed Capital Gain - Equity Funds (billions) <sup>2</sup>
1990	\$8	\$7	1%	\$240	\$2
1991	\$14	\$12	19%	\$405	\$77
1992	\$22	\$17	16%	\$514	\$82
1993	\$36	\$28	23%	\$741	\$170
1994	\$30	\$26	17%	\$853	\$145
1995	\$54	\$50	23%	\$1,249	\$287
1996	\$101	\$88	25%	\$1,726	\$432
1997	\$183	\$162	30%	\$2,368	\$710
1998	\$165	\$139	25%	\$2,978	\$745
1999	\$238	\$220	33%	\$4,042	\$1,334
2000	\$326	\$309	30%	\$3,962	\$1,189
2001	\$69	\$61	-7%	\$3,418	-\$239
2002	\$16	\$10	-28%	\$2,667	-\$747

Source: Investment Company Institute, "Mutual Fund Fact Book 2000," "Mutual Fund Fact Book 2003," May 2003 & "Perspective," February 2003.  
(1) Measured as a percent of equity fund assets as of October 31 of each year.  
(2) JEC Estimates  
(3) Detail may not add due to rounding.

## V. POLICY ALTERNATIVES

In order to increase the incentives for the average American to save and invest for the future and to improve tax neutrality, the realization point that triggers a capital gains tax liability should be changed from the mutual fund level to the shareholder level. This change would create a more equal tax treatment between investments in mutual funds and investments in direct stock ownership.

A bill (H.R. 496) introduced by Rep. Jim Saxton (R-NJ) addresses the problems taxable mutual fund investors face as outlined in this study. The bill would allow a deferral of capital gain distributions up to \$6,000 for married couples filing jointly and \$3,000 for all other tax filers.<sup>27</sup> The exclusion amounts would be indexed for inflation and the effective date of the legislation would be retroactive to January 1 of the year in which the bill is passed. Mutual fund companies would still make distributions, as required under current law. However, shareholders would have the ability to defer tax on the distributions until such time as they sold shares in the fund.

The deferral provision in Rep. Saxton's bill would provide substantial benefits to low- and middle-income taxpayers that invest in mutual funds. As highlighted in Table 4, for a hypothetical taxpayer with an initial \$10,000 investment in a mutual fund that returns 10 percent appreciation a year, the deferral on capital gain distributions could amount to \$13,700 over a 30-year period.<sup>28</sup> This represents almost an 11 percent greater *after-tax* return than would be achieved under the current law which unfairly taxes mutual fund capital gain distributions. The \$13,700 increase in *after-tax* return that would arise under the deferral provision of Rep. Saxton's bill is equivalent to approximately 137 percent of the original \$10,000 investment. The

<sup>27</sup> Representative Paul Ryan (R-WI) has introduced similar legislation (H.R. 1989) that would defer from taxation all mutual fund capital gain distributions.

<sup>28</sup> Using the 2002 median value of \$30,000 as the initial investment, the deferral on capital gain distributions could amount to \$40,951 over a 30-year period.

benefits of capital gain distribution deferral would significantly aid American families saving for their future.

<b>\$10,000 Initial Investment</b>						
<b>Time Horizon</b>	<b>5 - Years</b>	<b>10 - Years</b>	<b>15 - Years</b>	<b>20 - Years</b>	<b>25 - Years</b>	<b>30 - Years</b>
Pre-Liquidation Value With Deferral on Capital Gain Distributions	\$15,800	\$24,900	\$39,300	\$62,000	\$97,800	\$154,300
After-Tax Redemption Value	\$15,100	\$23,300	\$36,100	\$56,300	\$88,100	\$138,400
Pre-Liquidation Value Without Deferral on Capital Gain Distributions	\$15,400	\$23,600	\$36,200	\$55,500	\$85,200	\$130,900
After-Tax Redemption Value	\$15,100	\$22,900	\$34,900	\$53,200	\$81,500	\$124,800
After-Tax Difference (\$)	\$100	\$400	\$1,200	\$3,000	\$6,700	\$13,700
After-Tax Difference (%)	0.4%	1.6%	3.5%	5.7%	8.2%	10.9%

Note: Hypothetical Example - Assumes (1) an annual 10% rate of return; (2) of which dividends account for 30% of return and capital gain distributions account for 40% of return (3) distributions are reinvested net of taxes due. Hypothetical example is similar to that used by KPMG 2000 and does not account for state taxes. Dividends and capital gain distributions are taxed at new 15% rate, assumed throughout time period. Detail may not add due to rounding.

Previous research conducted by the Joint Economic Committee estimated the provisions in Rep. Saxton's bill would cover the vast majority of affected taxpayers. Based on estimates by the Joint Economic Committee using public data available from the IRS, approximately 85 percent of all married taxpayers who file tax returns jointly and claim capital gain distributions have net capital gain distributions that are under the exclusion amount (\$6,000) for their filing status and could defer all of their mutual fund capital gain distributions under Rep. Saxton's bill.

For all other filing statuses that claim capital gain distributions, approximately 80 percent would be able under the \$3,000 exclusion amount to defer all of their mutual fund capital gain distributions, according to JEC estimates.<sup>29</sup> In market conditions that result in a lower aggregate amount of capital gain distributions, it is very likely that the percentage eligible to defer all of their mutual fund capital gain distributions would increase to upwards of 90 percent – 95 percent.

The remaining taxpayers with capital gain distributions greater than the deferral ceiling would still be allowed to defer up to \$3,000 or \$6,000 of capital gain distributions, depending on filing status. However, these taxpayers would have to adjust their cost basis in the funds for which the capital gain distributions exceeded the deferral ceiling amount.

Rep. Saxton first introduced similar legislation in the 107<sup>th</sup> Congress as H.R. 168. That bill gained 70 cosponsors in the House of Representatives. The bill received widespread support and coverage in the media.<sup>30</sup> The Investment Company Institute, "on behalf of millions of mutual fund shareholders," wrote a letter signed by over 70 mutual funds to House Ways and Means

<sup>29</sup> U.S. Congress, Joint Economic Committee, "The Taxation of Mutual Fund Investors: Performance, Saving and Investment," April 2001.

<sup>30</sup> See, for example, Jim McTague, "Tax Buster: A Legislator Takes Aim at the Levy on Reinvested Capital Gains," *Barron's - Lipper Mutual Fund Quarterly*, January 7, 2002; Robert Barker, "Tax Bite Too Big on Your Mutual Funds?," *BusinessWeek*, January 28, 2002; Doug Fisher, "Taxing Matters: Proposed Legislation Could Level the Capital Gains Playing Field," *Fidelity Focus*, May 2002; John Curran, "Time to Fix the Fund Tax," *Mutual Funds*, July 2002; and Julie Earle, "Bill Offers Tax Hope for Mutual Fund Investors," *Financial Times*, February 4, 2003.

Committee Chairman Bill Thomas supporting Rep. Saxton's bill providing for tax deferral of mutual fund capital gain distributions.<sup>31</sup> Also, Lipper, a global leader in supplying mutual fund information, recognized that "with capital gains realizations expected to be low over the next couple of years, immediate implementation of this bill would benefit the taxable investor and have only a limited impact on government coffers."<sup>32</sup>

## VI. CONCLUSION

This study proposes that the tax law regarding mutual fund capital gain distributions be changed so that the point of realization that triggers a capital gains tax liability is moved from the mutual fund level to the individual level. This change would increase the efficiency, equity and simplicity of the tax system. In the long run, allowing for a deferral of capital gain distributions will improve economic efficiency by increasing the returns shareholders receive on their investment and would move toward more equal tax treatment between investments in mutual funds and investments in direct stock ownership.

The mutual fund industry has recently received much attention from legislators, regulators, media, and the public relating to corporate structures, trading fees and expenses, and potential abuses in the industry. Although all of these issues are important and result in additional "costs" to mutual fund investors and should be addressed fully, it is nonetheless extremely important that attention not be diverted from the most costly impact on mutual fund shareholder performance – taxes. Although mutual fund capital gain distributions have decreased from their record highs, unless legislative action is taken soon mutual fund capital gain distributions will inevitably increase and cause an unwelcome and unfair tax burden on millions of mutual fund shareholders, as has been the case previously.

The current policy of taxing reinvested mutual fund capital gain distributions results in significant lost returns for millions of mutual fund investors. For a hypothetical taxpayer with an initial \$10,000 investment in a mutual fund that returns 10 percent a year, the deferral on capital gain distributions would amount to a benefit of \$13,700 over a 30-year period *after taxes*. This represents an almost 11 percent greater *after-tax return* than would be achieved under current law, which unfairly taxes mutual fund capital gain distributions. The \$13,700 increase in *after-tax return* that would arise under the deferral provision of Rep. Saxton's bill (H.R. 496) is equivalent to approximately 137 percent of the original \$10,000 investment.

According to the Investment Company Institute, the median value of stock mutual funds held outside of employer-sponsored retirement plans in 2002 was \$30,000.<sup>33</sup> Assuming the same 10

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<sup>31</sup> A copy of the December 3, 2001 letter to Rep. Thomas is available online at: [http://www.ici.org/news\\_01\\_tax\\_relief\\_letter3.pdf](http://www.ici.org/news_01_tax_relief_letter3.pdf) and a copy of the accompanying Investment Company Institute press release is available online at: [http://www.ici.org/statements/nr/news\\_01\\_tax\\_relief\\_leg.html](http://www.ici.org/statements/nr/news_01_tax_relief_leg.html).

<sup>32</sup> Lipper, "Global Themes in the Mutual Fund Industry – 2002," March 2003, pg 49. Available online at: <http://www.research.lipper.wallst.com/researchStudiesOverview.asp>

<sup>33</sup> Investment Company Institute and the Securities Industry Association, "Equity Ownership in America," Washington, DC: Fall 2002, page 97.

percent rate of return, the deferral proposed under Rep. Saxton's bill could increase the *after-tax return* to the median shareholder by \$9,065 over 20 years and \$40,951 over 30 years. Though a change in the tax treatment of mutual funds would have a beneficial impact on all owners of mutual funds, the benefits would primarily accrue to those making less than \$100,000 a year, with 30 percent of households owning mutual funds earning less than \$50,000 a year.<sup>34</sup> The benefits of capital gain distribution deferral would significantly aid American families saving for their future.

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<sup>34</sup> Investment Company Institute, *Fundamentals: Investment Company Institute Research In Brief*, Vol. 12, No. 4. Washington, DC: October 2003.

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