JOINT ECONOMIC COMMITTEE

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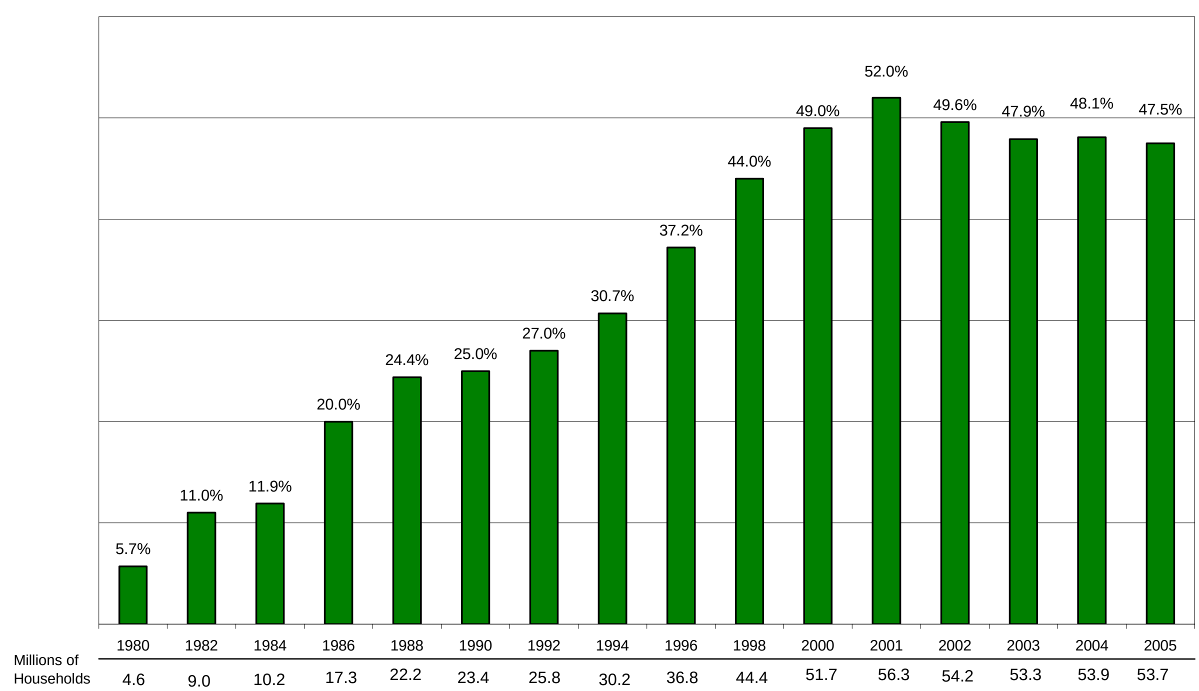
Providing Tax Equity for Mutual Fund Investors

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 households investing in mutual funds has increased more than 1,000 percent from 4.6 million households in 1989 to 53.7 million households in 2005 (Chart 1).

For many families, mutual funds are an important source of savings for retirement. However, mutual funds have one major drawback -- the annual taxation of capital gains distributed by the mutual fund to its shareholders. Even if individual shareholders do nothing more than buy and hold mutual fund shares, they typically are hit with potentially large tax payments due to the distribution of gains from their mutual funds. Shareholders are then either forced to sell assets to pay the tax, or divert financial resources from other more productive uses. On net, this tax treatment often reduces shareholder investment balances and returns.

Although direct owners of stocks pay taxes on dividends, 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 point that triggers a tax liability is the selling of securities by the individual owner. However, mutual fund investors face an additional tax trigger when mutual funds sell securities inside the fund. Thus, direct owners of stocks are allowed to defer taxation on the appreciated value of 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.

Chart 1 - U.S. Households Owning Mutual Funds, 1980-2005, Selected Years
(percentage and number of U.S. households)



Source: Investment Company Institute. "Fundamentals - U.S. Household Ownership of Mutual Funds in 2005," Vol. 14, No. 5. October 2005.

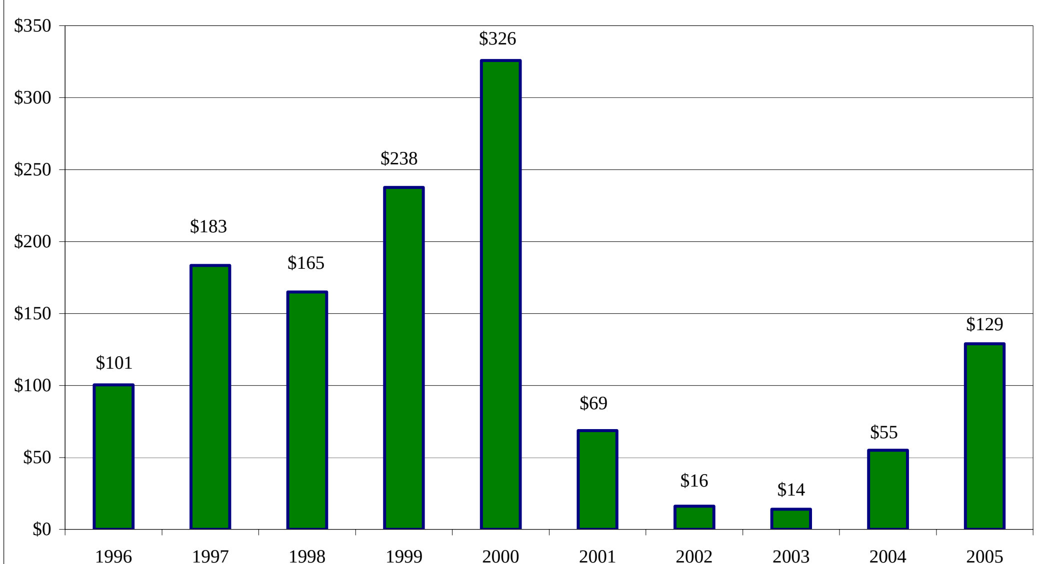
The current tax treatment of mutual fund shareholders violates the economic principle of horizontal equity and discriminates against taxpayers seeking the investment benefits of diversification through mutual funds instead of through direct ownership of stocks. This tax treatment is especially disadvantageous to many low- and middle-income households who invest in mutual funds because they lack the relatively large amount of capital necessary to build their own diversified portfolio of stocks.

In order to treat mutual fund shareholders and direct stock owners more equitably, taxpayers investing in mutual funds outside of individual retirement accounts should be allowed a tax deferral on reinvested capital gain distributions. In essence, this would provide a rollover treatment of these unrealized capital gains. The importance of correcting this inequity is becoming more urgent as mutual fund capital gain distributions are once sharply increasing. After reaching a recent low of $14 billion in 2003, mutual fund capital gain distributions increased to $55 billion in 2004, and have more than doubled from 2004 to $129 billion in 2005 (Chart 2).

Example	Stock	Mutual Fund	
		Current Law	Saxton Deferral Proposal (H.R. 196)
Initial Investment	$10,000	$10,000	$10,000
Long-term Capital Gain	$1,000	$1,000	$1,000
Reinvested Cap Gain Distribution	$0	$1,000	$1,000
Tax Due	$0	$150	$0
Net Value After Tax	$11,000	$10,850	$11,000

Congressman Jim Saxton (R-NJ) has developed a legislative solution,* which would provide a deferral of $5,000 for individuals and $10,000 for married couples on reinvested mutual fund capital gain distributions.

Chart 2 - Capital Gain Distributions to Mutual Fund Shareholders
All Types of Mutual Funds
(billions of dollars)



Source: Investment Company Institute. "Mutual Fund Factbook 2006."

***** H.R. 196, introduced by Rep. Jim Saxton (R-NJ). H.R. 2121, introduced by Rep. Paul Ryan (R-WI), would provide an uncapped deferral on reinvested mutual fund capital gain distributions.

For further information, please see the following Joint Economic Committee studies by visiting the JEC website www.house.gov/jec or by contacting the JEC at (202) 226-3234.

- *Providing Tax Equity for Mutual Fund Investors: Changing the Tax Treatment of Capital Gain Distributions* (April 2004)
- *The Taxation of Mutual Fund Investors: Performance, Saving and Investment* (April 2001)
- *Encouraging Personal Saving and Investment: Changing the Tax Treatment of Unrealized Capital Gains* (June 2000)