

MEMO# 13081

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SEC ADOPTS MUTUAL FUND AFTER-TAX RETURN DISCLOSURE RULES

[13081] January 24, 2001 TO: BOARD OF GOVERNORS No. 8-01 ACCOUNTING/TREASURERS MEMBERS No. 3-01 SEC RULES MEMBERS No. 8-01 TAX MEMBERS No. 7-01 TRANSFER AGENT ADVISORY COMMITTEE No. 9-01 RE: SEC ADOPTS MUTUAL FUND AFTER-TAX RETURN DISCLOSURE RULES The Securities and Exchange Commission has adopted rule and form amendments to require an open-end management investment company ("fund") to disclose standardized after-tax returns.¹ These amendments were adopted largely as proposed,² with certain modifications in response to comments submitted by the Institute and other commenters. The new after-tax disclosure requirements are summarized below, and a copy of the Adopting Release is attached.

1. Types of Return to Be Disclosed The Commission has adopted as proposed the requirement that funds disclose after-tax returns for one-, five-, and ten-year periods on both a "pre-liquidation" and "post-liquidation" basis. As recommended by the Institute, the SEC modified the proposal to eliminate disclosure of pre-liquidation before-tax returns. This will result in three, rather than four, types of return, which are as follows (all of which are net of all fees and charges): (1) before-tax return; (2) return after taxes on distributions (pre-liquidation); and (3) return after taxes on distributions and redemption (post-liquidation).

2. Location of Required Disclosure

a. Prospectus Disclosure The Commission has adopted as proposed the requirement that funds disclose after-tax returns in the performance table contained in the risk/return summary of the prospectus. This 1 Disclosure of Mutual Fund After-Tax Returns, SEC Release Nos. 33-7941; 34-43857; IC-24832 (January 18, 2001) ("Adopting Release") (available at www.sec.gov/rules/final).

2 See Memorandum to Board of Governors No. 15-00, Accounting/Treasurers Members No. 11-00, SEC Rules Members No. 19-00, and Tax Members No. 19-00, dated March 21, 2000. 2will also have the effect of requiring after-tax return disclosure in any fund profile, because a fund profile must include the prospectus risk/return summary. The Institute opposed this requirement and recommended instead that the disclosure be included in the tax section of the prospectus, where it would be in one centralized location and would avoid overwhelming the risk return summary. The Adopting Release explains, however, that disclosure in the risk/return summary is required because, given that past performance information is an important part of an investors' decisionmaking process, it is critical that after-tax returns be disclosed in the same location as before-tax returns.

b. Management's Discussion of Fund Performance As recommended by the Institute, the Commission did not adopt the proposal to require after-tax return disclosure in the Management's Discussion of Fund Performance ("MDFP"), which is typically contained in the annual report. Funds will, however, be required to include a statement in the MDFP that accompanies the performance table and graph to the effect that the returns shown do not reflect the deduction of taxes that a shareholder would pay

on fund distributions or the redemption of fund shares. This disclosure is required to avoid potential investor confusion on this point.

3. Format of Disclosure

a. Tabular Format The Commission has adopted as proposed the requirement that before- and after-tax returns be presented in a standardized tabular format. Specifically, funds must present before- and after-tax returns for one-, five-, and ten-year periods using the following captions: (1) Return Before Taxes; (2) Return After Taxes on Distributions; and (3) Return After Taxes on Distributions and Sale of Fund Shares. The table must also include, as currently required, the returns of an appropriate broad-based securities market index. The Adopting Release notes that when multiple funds or series are offered in a single prospectus, the before- and after-tax returns of each fund must be adjacent to one another in order to facilitate fund comparisons. Thus, a prospectus may not, for example, present the before-tax returns for all funds, followed by the after-tax returns for all funds.

b. Multiple Class Funds As the Institute recommended, a fund offering multiple classes in a single prospectus need only present the after-tax returns for one class. The class selected must be offered to investors who hold their shares through taxable accounts and have returns for at least ten years, or if no such class has ten years of returns, then the class with the returns for the longest period should be selected. In addition, the narrative that accompanies the performance table must explain that the after-tax returns are for only one class offered by the prospectus and that the after-tax returns for other classes will vary. The amendments also require that the after-tax returns for the one class presented must be adjacent to the before-tax returns for that class, rather than interspersed with the returns of other classes or funds.

34. Exemptions from the Disclosure Requirement

a. Money Market Funds and Tax-Deferred Investment Vehicles As proposed, the Commission has exempted money market funds from the requirement to disclose after-tax returns. In addition, the amendments were modified slightly to permit a fund to omit the after-tax return information in a prospectus used exclusively to offer fund shares as investment options for defined contribution plans and similar arrangements, including: (1) a defined contribution plan that meets the requirements for qualification under Section 401(k) of the Internal Revenue Code; (2) a tax-deferred arrangement under Section 403(b) or 457 of the Code; (3) a variable contract as defined in Section 817(d) of the Code; (4) a similar plan or arrangement pursuant to which an investor is not taxed on his or her investment in the fund until the investment is sold; or (5) entities that are not subject to the individual federal income tax (e.g., tax-exempt foundations, colleges, and corporations).

b. Bond Funds The Commission did not exclude bond funds generally from the requirement to disclose after-tax returns, although the Institute and others recommended that those funds be excluded. The Adopting Release explains that although investors more readily understand the tax impact of owning a bond fund that makes few, if any, capital gains distributions, than the tax impact of owning other funds, bond funds may have significant capital gains or losses, and such information should be made available to their shareholders. With respect to tax-exempt bond funds, the Adopting Release explains that while most, if not all, income distributed by a tax-exempt fund generally will be tax-exempt, a tax-exempt fund may also make capital gains distributions that are taxable and an investor is taxed on gains from the sale of fund shares. As a result, the performance of a tax-exempt fund may be affected by taxes, and taxes may have a greater or lesser impact on different tax-exempt funds.

5. Advertisements and Other Sales Literature As adopted, the amendments require all fund advertisements and sales literature that include after-tax performance information to include after-tax returns computed according to the standardized formulas. In addition, any quotation of non-standardized after-tax returns will be subject to the same conditions currently applicable to quotations of non-standardized performance that are included in fund advertisements and sales literature. As recommended by the Institute, the amendments require the inclusion of standardized after-tax returns in any advertisement or sales literature that includes a

quotation of performance and that represents or implies that the fund is managed to limit or control the effect of taxes on performance. The Adopting Release notes that the after-tax return disclosure requirement does not apply to advertisements or sales literature for a fund that is eligible to use a name suggesting that the fund's distributions are exempt from federal income tax or from both federal and state income tax under Rule 35d-1 under the Investment Company Act (the Commission's recently- adopted fund name rule). 46.

Formulas for Computing After-Tax Return The Commission has adopted, with some modifications, the proposed requirement that funds compute after-tax returns using standardized formulas that are based largely on the current standardized formula for computing before-tax average annual total return. After-tax returns will be computed for one-, five-, and ten-year periods assuming a hypothetical \$1,000 one-time initial investment, and the deduction of the maximum sales load and other charges from the initial \$1,000 payment.

a. Tax Bracket The Commission has adopted as proposed the requirement that standardized after-tax returns be calculated assuming that distributions by the fund and gains on a sale of fund shares are taxed at the highest applicable individual federal income tax rate. The Adopting Release states that the use of the maximum tax rates provide a "worst-case" federal income tax scenario. This data, when coupled with before-tax returns, which reflect the imposition of taxes at a 0 percent tax rate, will effectively provide investors with the full range of historical after-tax return information. The Commission rejected the argument asserted by the Institute and others that the use of an intermediate tax rate would more appropriately reflect the rate applicable to the typical fund investor, and that the use of the highest tax rate would not be applicable or meaningful to the typical investor and, thus, could significantly overstate the tax consequences of moderate- income investors who invest in taxable funds, as well as the tax impact of a fund's ordinary income distributions. In the Commission's view, any benefits of using an intermediate rate would be outweighed by the complexity of determining the appropriate rate from one year to the next as tax rates and the income of a typical fund investor change. Also, using a specific rate (e.g., 28 percent) or a specific income level (e.g., \$55,000) would require the Commission to continually monitor the changing demographics of mutual fund investors, as well as changing tax laws, and update the rules accordingly. Instead, the Commission encourages funds to provide their investors with additional information that is tailored to a particular fund's typical investor, or to make available to investors after-tax returns calculated using multiple tax rate assumptions. The Commission added that funds can supply this information through the use of calculators on fund websites or disclosure elsewhere in the prospectus of returns calculated based on different tax rate assumptions.

b. Capital Gains and Losses Upon a Sale of Fund Shares The Commission has adopted, substantially as proposed, the requirement that after-tax, post-distribution returns, be computed assuming a complete sale of fund shares at the end of the one-, five-, or ten-year measurement period, resulting in capital gains taxes or a tax benefit from any resulting capital losses. Also, a fund must track the actual holding periods of reinvested distributions and may not assume that they have the same holding period as the initial \$1,000 investment. 5The Institute opposed this approach, recommending instead that funds be permitted to calculate taxes on gains realized upon a sale of shares at the end of the one-year period (i.e., short-term capital gains) as if the shares had been held for one year and one day, since most shareholders likely would hold the shares for the extra day in order to receive favorable long- term capital gain treatment. The Adopting Release explains, however, that it is important to disclose to shareholders the ramifications of redeeming fund shares within the one-year period, and added that if the Commission were to prescribe a special rule for one-year returns, it would have to be re-evaluated in light of subsequent changes in tax law, such as increases to the holding period required for long-term gain treatment.

c. Other Assumptions The Commission has adopted as proposed

certain assumptions required in the computation of after-tax returns. Specifically, the amendments require the after-tax return computation to: (1) use historical tax rates; (2) be based on calendar-year periods; (3) exclude state and local tax liability; (4) not take into account the effect of either the alternative minimum tax or phaseouts of certain tax credits, exemptions, and deductions for taxpayers whose adjusted gross income is above a specified amount; (5) assume that any taxes due on a distribution are paid out of that distribution at the time it is reinvested and reduce the amount reinvested; and (6) assume that the taxable amount and tax character (e.g., ordinary income, short-term capital gain, long-term capital gain) of each distribution are as specified by the fund on the dividend declaration date, adjusted to reflect subsequent recharacterizations. With respect to determining the tax consequences of fund distributions, the Adopting Release states that funds generally should apply the tax law in effect on the date the distribution is reinvested. In response to concerns raised by the Institute and others about whether a fund that has elected to pass through foreign tax credits to its shareholders may reflect the foreign tax credit in after-tax returns, the amendments provide that the effect of applicable tax credits, such as the foreign tax credit, should be taken into account in accordance with federal tax law.

d. Narrative Disclosure The Commission has adopted as proposed the requirement that funds include a short, explanatory narrative adjacent to the performance table in the risk/return summary. The Commission has not mandated any specific language for the narrative, however, the use of plain English is required. The required narrative has been streamlined to require disclosure that: (1) after-tax returns are calculated using the historical highest individual federal marginal income tax rates, and do not reflect the impact of state and local taxes; and (2) actual after-tax returns depend on the investor's tax situation and may differ from those shown, and the after-tax returns shown are not relevant to investors who hold their fund shares through tax-deferred arrangements such as 401(k) plans or individual retirement accounts. Moreover, a fund must provide a statement to the effect that the fund's past performance, before and after taxes, is not necessarily an indication of how the fund will perform in the future.

67. Effective and Compliance Dates

a. Effective Date The adopted rule and form amendments become effective April 16, 2001.

b. Compliance Date for Prospectuses All post-effective amendments that are annual updates to effective registration statements and profiles filed on or after February 15, 2002 must comply with the amendments to Form N-1A. The Adopting Release adds that the Commission will not object if existing funds file their first annual update complying with the amendments pursuant to Rule 485(b) of the Securities Act of 1933, provided that the post-effective amendment otherwise meets the conditions for immediate effectiveness under the rule.

c. Compliance Date for Advertisements and Sales Materials All fund advertisements and sales materials must comply with the amendments by October 1, 2001. The Adopting Release states that compliance with this date is only required for those funds that voluntarily choose to include after-tax returns in advertisements or sales literature, or that claim to be managed to limit or control the effect of taxes on performance and include performance information in these materials.

Barry E. Simmons Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 13081. ICI Members may retrieve this memo and its attachment from ICINet (<http://members.ici.org>). Attachment (in .pdf format)

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