COMMENT LETTER

February 7, 2007

Submission to U.S. Chamber of Commerce Commission, February 2007

Statement of the Investment Company Institute Addendum to January 26 Submission to U.S. Chamber of Commerce Commission
on the
Regulation of U.S. Capital Markets in the 21st Century
February 7, 2007

The Investment Company Institute wishes to expand upon its submission to the U.S. Chamber of Commerce Commission on the Regulation of U.S. Capital Markets in the 21st Century to underscore our support for enhanced tax efficiencies in the mutual fund market. As explained in the Institute's January 26 submission, important tax efficiencies will result from passage of legislation that defers taxes for mutual fund shareholders on reinvested capital gains distributions. Such legislation, strongly supported by the Institute, was introduced in the last Congress as the Generate Retirement Ownership Through Long-Term Holding Act of 2005 (the "GROWTH Act").1

Current tax burdens on mutual funds contribute to burdens on investment and saving for retirement. Under present law, mutual funds are required to distribute annually the income and gains they realize from portfolio investments. Investors with taxable accounts are taxed on these distributions even if they are reinvested in the fund. Thus, individuals may owe taxes on their mutual fund investments even though they have not received any distributions from the fund. The GROWTH Act addresses this disparity by deferring tax on automatically reinvested capital gain distributions until fund shares are sold. This legislative change would allow Americans, particularly those with more modest incomes and no access to an employer-sponsored retirement plan, to save more for retirement.2 Importantly, it also would make U.S. funds more competitive with foreign funds for foreign shareholders.

Increased Retirement Savings

By deferring taxation, the GROWTH Act would keep more retirement savings invested longer. These savings then would grow at a greater rate because the reinvested gains would compound, untaxed, in the fund. A vast majority of individuals holding mutual fund shares outside of an employer-sponsored plan are saving primarily for retirement.3 The GROWTH Act furthers this goal.

While the GROWTH Act would assist all mutual fund investors, the primary beneficiaries of this change would be those making less than $100,000 a year.4 Mutual funds represent the most readily available and affordable option for retirement planning for investors in this category. Seventy percent of all fund investors have household incomes under $100,000, and 28 percent of households owning mutual fund shares earned less than $50,000 a year.[5] Shareholders' median household income in 2005 was $68,700.[6]

The Congressional Joint Economic Committee estimates that the current tax treatment of mutual funds costs the average mutual fund investor between 10 and 20 percent a year in lost returns.[7] From 1995 to 2000, taxes effectively cost fund shareholders about 2.3 percentage points a year in their rate of return.[8] This means that current tax law will cost an investor with $10,000 invested in a fund earning 10 percent annually over thirty years almost $82,000.[9]

For most investors, this lost return represents a significant decrease in retirement savings. Passage of the GROWTH Act would allow mutual fund shareholders to grow their investments at a greater rate, resulting in increased retirement security.

The current tax treatment of mutual funds also results in an economic disadvantage to mutual fund shareholders, as compared to investors who own stock directly. Unlike mutual fund shares, shares of stock held directly are not taxed on their appreciated value until such shares are sold. This mutual fund disadvantage falls primarily upon moderate-income investors, who are the primary holders of mutual fund shares. Unlike their wealthier counterparts, such investors cannot afford to build their own diversified portfolio of stocks. Passage of the GROWTH Act would eliminate this inconsistency and encourage investment and retirement savings, particularly among less wealthy Americans.

Competitiveness with Foreign Funds

In addition to increasing retirement savings, the GROWTH Act would make U.S. mutual funds more competitive with foreign funds. Many European funds "roll up," or retain (rather than distribute), their income and gains. Unlike current tax treatment in the U.S., these amounts are taxed only when investors redeem their fund shares. Thus, these foreign funds are more attractive to foreign investors than U.S. mutual funds.

Ireland and Luxembourg are the two primary competitors of the U.S. in the world mutual fund market. Funds in Ireland and Luxembourg roll up their income and gains. From 1998 to 2005, the combined total net assets of Irish and Luxembourg mutual funds increased by $1.6 trillion, from $560 million to $2.2 trillion. This increase represented nearly 50 percent of the increase in all European funds for the same time period.[10]

Passage of the GROWTH Act would encourage foreign investment in U.S. mutual funds. If enacted, U.S. funds would attract foreign investment by offering the same tax treatment available to foreign funds. Foreign investment in the U.S. would make U.S. capital markets more efficient, grow the U.S. economy, and stimulate job growth. Further, increased assets under management by U.S. mutual funds would spread fund costs over more investors, reducing costs for all and, in turn, stimulating savings.

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For these reasons, we urge the Commission to support enactment of the GROWTH Act. This legislation is important to the retirement security of mutual fund investors and the ability of U.S. funds to compete in global markets.

ENDNOTES

1 The House version of the GROWTH Act (H.R. 2121) was introduced, with 73 co-sponsors, on May 5, 2005. The Senate version (S. 1740) was introduced on September 21, 2005, with 6 co-sponsors. Both bills garnered bipartisan support.

2 The U.S. currently has a negative savings rate. Incentives to save, such as the GROWTH Act, will help reverse this savings shortfall.

3 In an Institute survey, 75 percent of respondents who own mutual funds outside of employer-sponsored plans indicated that their primary financial goal was to save for retirement. Investment Company Institute, 1998 Profile of Mutual Fund Shareholders, Summer 1999, Figure 51, page 80.

4 Joint Economic Committee, United States Congress, Encouraging Personal Saving and Investment: Changing the Tax Treatment of Unrealized Capital Gains, June 2000, p. i.

5 Investment Company Institute, Research Fundamentals, Vol. 15, No. 6 (October 2006), p. 5, figure 6.

6 Investment Company Institute, 2006 ICI Fact Book, p. 49.

7 Joint Economic Committee, p. 10.

8 Id. (citing Jeffrey Laderman and Amy Barrett, "Mutual Funds: What's Wrong," Business Week, January 24, 2000, p. 72).

9 Id.

10 As of 2005, the worldwide total net assets of European mutual funds was $6 trillion. 2006 ICI Fact Book, Table 44. Total net assets for U.S. mutual funds for 2005 was $8.9 trillion.
