

COMMENT LETTER

October 12, 2001

Letter to the Department of Treasury on Shareholder Tax Relief, October 2001

October 12, 2001 The Honorable Paul H. O'Neill Secretary Department of the Treasury 1500 Pennsylvania Avenue, NW Washington, DC 20220 Dear Secretary O'Neill: We regret that our meeting with you on October 12 to discuss the Administration's economic stimulus package needed to be postponed. As Chairman of the Board of Governors of the Investment Company Institute -- which represents more than 7000 mutual funds and 92 million shareholders -- my colleagues and I wanted to be certain that you knew the most important message we would have delivered at the meeting. As the President leads the nation in responding to the horrific events of September 11th, the mutual fund industry is prepared to do all we can to support his efforts to strengthen our economy and reinforce the public's confidence in our nation's future. With respect to the economic stimulus package, we planned to share an intriguing idea that you may wish to consider. The proposal, in a nutshell, is to change the anomalous tax policy that applies to long term mutual fund shareholders who hold rather than sell shares. As you know, mutual fund investors are overwhelmingly middle income Americans saving for their children's education or their own retirement. In just the past few years, however, more than 30 million mutual fund investors have been required to pay an annual, long-term capital gains tax even though they did not sell any of their fund shares and took no other action to realize a capital gain. Our proposal is to permit mutual fund investors to defer the annual long-term capital gains tax owed if the distribution that triggered the tax is reinvested and the individual takes no action to realize a capital gain. Short term gains and dividends would not be covered. This limited form of capital gains relief has numerous policy and political advantages. As outlined below, we believe deferring the long-term capital gains tax on mutual fund distributions would be a popular, effective and relatively non-controversial element of a stimulus package. Most important, this proposal would immediately reduce the taxes and ease the frustration level of tens of millions of middle income taxpayers by deferring the annual tax on their long term mutual fund investments until they actually take action to realize gains. The Honorable Paul H. O'Neill October 12, 2001 Page 2 of 3 First, deferring the tax on a mutual fund's long-term capital gain distributions would help stimulate the economy quickly. It does so by putting money into the hands of millions of mostly middle income Americans beginning in the first quarter of 2002, and annually thereafter. In just a few months, millions of Americans would either send a smaller check to the IRS or receive a larger refund. In some cases, taxpayers who would have owed taxes will instead receive refunds. As with the President's rebate earlier this year, taxpayers could use this savings in any manner they see fit. Second, to enjoy the benefit of deferral and reduce their taxes, mutual fund shareholders would have to reinvest their distribution in the fund that distributed it. Once they choose to sell their shares, the deferred capital gains tax would be due. This is a

unique and important distinction: the proposal would provide significant capital gains tax relief to the overwhelming majority of Americans who receive capital gains, while simultaneously encouraging continued long term investment in our markets. Third, because the proposal involves deferring rather than excluding taxes, the long-term cost to the federal government is minimized. From an accounting rather than budget-scoring perspective, the government loses primarily just the time-value of the deferred capital gains taxes. In effect, the time-value of these tax payments is transferred to the fund shareholder. In this general sense, the proposal simply extends the long-term capital gains tax treatment applicable to individual stocks to individual mutual funds. Fourth, the capital gains tax deferral we are proposing is limited. Taxes on dividends and short-term gains distributed by mutual funds would still be due in the year the distributions are made. The tax on long-term capital gains distributions would be the only one eligible for deferral. In addition to providing a reason for investors to hold their mutual funds for the long term, mutual fund managers will have an added incentive to pursue long-term rather than short-term investment gains. Finally, there are several reasons why this idea could quickly attract broad support. Mutual fund investors are overwhelmingly middle-income, middle-aged and family oriented individuals. Moreover, unlike wealthier Americans who often own a broad range of complex investments, mutual fund investors typically own accounts of modest size, and hold few other investments. Many lack the time or resources needed to take full advantage of complex tax rules that could potentially reduce the tax obligations triggered by annual capital gains distributions. As you are undoubtedly aware, dissatisfaction with the tax consequences of a mutual fund's annual distributions is discussed frequently and prominently in the media. Despite substantial educational efforts, bewildered investors do not understand why they must pay a long-term capital gains tax when they took no action to realize a capital gain. Editorial writers and personal finance experts across the political spectrum The Honorable Paul H. O'Neill October 12, 2001 Page 3 of 3 have taken up this issue and strongly support deferring the tax on long-term gains distributed by mutual funds. In fact, we are unaware of any editorials or columns that oppose the idea. Additionally, there is significant Congressional interest in solving this problem. If you or your staff would like to discuss in greater detail how deferring the tax on mutual fund capital gain distributions would contribute to an economic stimulus package, please contact me at (609) 282-2004, or Matthew Fink, President of the ICI, at (202) 326-5801. Again, the Institute and the mutual fund industry remain prepared to assist the Administration in any possible way in these challenging days for our country. Very truly yours, Terry Glenn Chairman, Board of Governors Chairman of the Americas President, Merrill Lynch Funds cc: The Honorable Mark A. Weinberger Ms. Pamela F. Olson J.D. Foster substantially similar letter sent to The Honorable Donald L. Evans Secretary U.S. Department of Commerce