# ENCOURAGING PERSONAL SAVING AND INVESTMENT: CHANGING THE TAX TREATMENT OF UNREALIZED CAPITAL GAINS

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**Joint Economic Committee**
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**Abstract**

To increase personal saving and investment and to promote tax neutrality among various investment vehicles, the tax treatment of capital gains unrealized by shareholders should be modified. The current practice of forcing distributions of capital gains to mutual fund shareholders should be changed. Until the shareholder realizes a capital gain through the sale of an asset, no tax liability should incur. With respect to regulated investment companies, the realization point that triggers a capital gains tax liability should be moved from the corporate level down to the individual shareholder level. Since mutual funds are a popular vehicle for saving and investment of middle-income households, this tax reform would greatly increase the incentives for these people to invest and save for their future by increasing their pre-liquidation rate of return.

The current tax treatment of mutual funds causes the average mutual fund investor to lose between 10 percent and 20 percent a year of their pre-liquidation rate of return. On a $10,000 investment earning a 10 percent annual rate of return, a 2.3 percentage point reduction in the pre-liquidation rate of return would cost a mutual fund investor almost $82,000 over a 30 year period -- on a $26,000 investment a mutual fund investor would forego approximately $213,000 over a 30 year period.

A change in the tax treatment of mutual funds 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, with 43% of households owning mutual funds earning less than $50,000 a year.

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# ENCOURAGING PERSONAL SAVING AND INVESTMENT: CHANGING THE TAX TREATMENT OF UNREALIZED CAPITAL GAINS

## EXECUTIVE SUMMARY

This study examines the tax treatment of unrealized capital gains as they relate to forced distributions associated with regulated investment companies (such as mutual funds). Regulated investment companies pool investment money from numerous shareholders and invest in a diversified portfolio of securities to minimize risk and maximize returns. Increasingly, regulated investment companies, such as mutual funds, have become an important vehicle for middle-income households to invest in the stock market and save for the future.

Shareholders pay taxes on dividends earned by mutual funds as distributed by the companies in which the mutual fund owns stocks or bonds. Furthermore, shareholders pay taxes on the appreciation of their mutual fund shares when they sell their shares for more than the original purchase price. The selling of mutual fund shares creates a capital gain or, if the shares are sold for less than the original purchase price, a capital loss. Unfortunately, the current tax laws can force shareholders of mutual funds to pay capital gains taxes on their mutual funds even when shareholders choose not to sell shares.

Specifically, this report finds:

- In order to increase saving and investment by individuals and to promote tax neutrality among various investment vehicles, the tax treatment of unrealized capital gains should be modified.
- With respect to regulated investment companies, the realization point that triggers a capital gains tax liability should be moved from the corporate level down to the individual shareholder level.
- Since mutual funds are a popular vehicle for saving and investment of middle-income households, this tax reform would greatly increase the incentives for these people to invest and save for their future by increasing their pre-liquidation rate of return.
- The current tax treatment of mutual funds causes the average mutual fund investor between 10 percent and 20 percent a year in lost return.
- On a $10,000 investment earning a 10 percent annual rate of return, a 2.3 percentage point reduction in the pre-liquidation rate of return would cost a mutual fund investor almost $82,000 over a 30 year period – on a $26,000 investment a mutual fund investor would forego approximately $213,000 over a 30 year period.
- A change in the tax treatment of mutual funds would have a beneficial impact on all owners of mutual funds, but the benefits would primarily help those earning less than $100,000 a year.

# ENCOURAGING PERSONAL SAVING AND INVESTMENT: CHANGING THE TAX TREATMENT OF UNREALIZED CAPITAL GAINS

The "right" amount of saving, the decision to allocate income to future rather than current consumption, is important to a nation's economic growth. Tax policy can, and often does, affect the saving decision through a variety of channels.

*B. Douglas Bernheim and John Karl Scholz*[1]

## I. INTRODUCTION

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.[2]

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

Realization of capital gains is the point in time at which ownership of capital assets, or various rights to 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 gains taxes should be levied on *unrealized* capital gains. 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.

For example, if the stock price of Company XYZ was $100 on January 1 and ended the year at $150, shareholders of Company XYZ would have an unrealized gain of

[1] B. Douglas Bernheim, and John Karl Scholz. "Saving, tax and." In Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle (Editors). *The Encyclopedia of Taxation and Tax Policy*. The Urban Institute Press, 1999, page 325.

[2] For more information, see United States Congress. Joint Economic Committee. *Tax Reduction and the Economy*. April 1999.

$50. The capital gain ($50) is unrealized if the shares are not redeemed for cash, but are instead retained for the future.

Obviously, the taxation of unrealized capital gains would force taxpayers to either sell capital assets or channel money from some other productive source in order to pay the tax bill. Fortunately, the current tax system generally doesn't impose such an onerous tax on investors by taxing their unrealized capital gains. However, the devil is in the details in how "*realization*" is defined.

Realization, for purposes of taxing capital gains, is considered to be the point in time at which ownership of capital assets, or various rights to capital assets, are exchanged for money. This seems straightforward in the following example: An individual owns 100 shares of stock in Company XYZ, which were purchased for $100 (for a total cost of $10,000). The individual later sells all 100 shares on the open-market for $150 each, or $15,000. The individual has exchanged the shares for money. This creates a realized capital gain of $5,000 and a tax liability to the investor.

However, the concept of realization can be confusing for mutual fund shareholders. Mutual fund shareholders pay taxes on dividends earned by mutual funds as distributed by the companies in which the mutual fund owns stocks or bonds. Additionally, shareholders pay taxes on the appreciation of their mutual fund shares when they sell their shares for more than the original purchase price. The selling of mutual fund shares creates a capital gain, or if the shares are sold for less than the original purchase price a capital loss. Unfortunately, the current tax law treatment of capital gains realization also can force shareholders of mutual funds to pay capital gains taxes on their mutual funds even when shareholders choose not to sell shares.

This situation occurs in the following example: An individual owns 1,000 shares in Mutual Fund ABC, which were purchased for $10 per share (for a total cost of $10,000). The shares of the mutual fund represent ownership, or various rights to capital assets, in the mutual fund. In the course of the mutual fund's normal buying and selling of securities, any assets that are sold by the mutual fund at a price in excess of that at which they were purchased creates a realized capital gain and a tax liability. If Mutual Fund ABC realizes capital gains of $1 per share, the individual investors are responsible for the tax liability even if they themselves haven't "realized" or exchanged their shares for money. Even though the gains are reinvested, this is considered to be a realized gain to the mutual fund company. The tax liability is passed-through to the individual shareholders even though this is an *unrealized* gain to the shareholders of the mutual fund.

In the previous example, the mutual fund shareholder would be responsible for capital gains tax on $1,000, or $1 for each of the 1,000 shares owned of Mutual Fund ABC. This is because the mutual fund company is deemed by the tax laws to have "realized" a capital gain and, hence, tax is due. This is the case even if individual shareholders do not redeem any shares and the mutual fund reinvests the gain in other capital assets.

Although only a few corporate investment structures are required to pass-through gains (and the tax liability) onto their shareholders, the most prevalent type of investment vehicles affected by this tax quirk in the definition of “realization” are mutual funds.

Mutual funds pool investment money from numerous shareholders and invest in a diversified portfolio of securities to minimize risk and maximize returns. Increasingly, mutual funds have become an important vehicle for low- and middle-income households to invest in the stock market and save for the future.

Throughout the course of a mutual fund’s normal operations, fund managers buy and sell securities 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 gain. The gains mutual funds distribute to individual shareholders are subject to capital gains taxation on the individual’s 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 a potentially large tax liability due to the distribution of gains from their mutual funds. Shareholders are then forced to either sell assets to pay the tax liability, or divert funds from other sources. This creates an opportunity cost to the shareholder and can result in lost economic gain due to compounding.

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 realization point that triggers a tax liability is the selling of securities by the individual owner. In the case of mutual funds, the realization point that triggers a tax liability for shareholders is the selling of securities by the mutual fund in addition to the sale of the mutual funds shares by mutual fund shareholders.

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 don’t sell (i.e., redeem) any of their mutual fund shares. The current tax treatment of mutual funds is an economic disadvantage to low- and middle-income households, who invest in mutual funds because they cannot afford the relatively large amounts of capital necessary to build their own diversified portfolio of stocks.

In order to treat mutual fund shareholders and direct stock owners more equally, and to further increase and encourage saving and investment, the realization point that triggers a capital gains tax liability should be moved from the mutual fund level down to the individual shareholder level. In essence, this would provide a rollover treatment of unrealized capital gains.

As the current U.S. Treasury Deputy Assistant Secretary for Tax Analysis Leonard Burman states with respect to rollover of gains in general: "Advocates of this approach argue that the tax code should distinguish between sales of assets to finance consumption and sales in which the proceeds are reinvested. It might also be argued that this option is a natural extension of the realization principle of taxation: that is, tax is due only when the owner of an asset has exchanged it for cash."[3] With respect to mutual funds, the ultimate economic owners of the assets of the mutual fund are its individual shareholders, not the mutual fund.

Furthermore, since mutual funds are a popular vehicle for saving and investment of low- and middle-income households, this tax reform would greatly increase the incentives for these people to invest and save for their future by increasing their rate of return. As Burman also states: "Deferral reduces the effective tax rate on assets that pay returns in the form of capital gains much more than on income-producing assets. Because the tax can be deferred, the money that would have gone to pay taxes can continue to earn returns until the tax is paid."[4]

The cost to the federal government of adopting the tax change proposed in this paper to the treatment of "unrealized" capital gains would be minimal. Any loss would primarily result from the time value of money, as taxation of gain is not forgone, but rather deferred until the shareholder sells their individual mutual fund shares. However, the gain to the individual investor is very significant. Furthermore, if the market rate of return on any deferred shareholder gain is greater than the interest rate of the government 30-year bond, the government would realize an overall revenue gain.

# II. HISTORICAL BACKGROUND

The original rationale for the current tax treatment of mutual funds (referred to as "regulated investment companies" by the Internal Revenue Code) can be traced to the *Revenue Act of 1936*. Prior to that Act, corporate income was subject to the same tax rate regardless of whether their profits were distributed. The corporate tax rate was 13.75 percent on the eve of the Act.

Also, at this time, a surtax was applied to individual taxpayers who received profits from corporate dividends. This surtax ranged from 4 percent to 63 percent. Hence, for many individuals, the individual surtax rate was substantially higher than the

[3] Leonard Burman. *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*. Washington, DC: The Brookings Institution, 1999, page 136.

[4] *Ibid*., page 48.

corporate tax rate. Thus, many individuals could have had an incentive to avoid the burdensomely high individual surtax rate by shifting their investments to corporations with low rates of distribution, thus obtaining a tax deferral based on the difference between their marginal surtax rate and the corporation tax rate on undistributed profits.

In response to tax avoidance concerns, the *Revenue Act of 1936* imposed an additional level of corporate income tax, or a surtax, on the undistributed profits of a corporation. This surtax was in addition to the regular tax on distributed and undistributed profits. However, since a mutual fund represents a vehicle for a large number of small investors to pool their risks in order to diversify and secure good investments, mutual funds were allowed special tax treatment.

Since mutual funds (or regulated investment companies) are defined as firms investing primarily in stock or securities and deriving their income primarily as dividends, interest, and capital gains, they are exempt from taxation on the profits they distribute to their shareholders. Mutual funds are taxed at the corporate tax rate on any undistributed profits.

Section 13(a)(3) of the *Revenue Act of 1936* allowed for this special treatment and endures today under Subchapter M of the *Internal Revenue Code of 1986*. To qualify as a regulated investment company under Subchapter M, a mutual fund company must distribute to its shareholders at least 90 percent of fiscal year earnings. Additionally, a mutual fund must distribute to its shareholders 98 percent of its earnings over every 12-month period ending October 31 and a every calendar year ending December 31.[5]

Hence, one justification for imposing a surtax on undistributed corporate profits was concern for avoidance of federal income tax by high income individuals. The surtax imposed as a result of the *Revenue Act of 1936* gave an incentive for corporations to distribute profits to individual shareholders as dividends, even though the distributions could be taxed at higher marginal rates. Given that the individual capital gains tax rates are currently lower than the corporate tax rate and that mutual funds represent a vehicle for a large number of small investors to pool their risks and secure good investment counsel, the tax reasons behind forcing the distribution of profits from the mutual fund to the individual shareholder may no longer be justified.

The retained profits of the fund should not be taxed because these profits are invested in assets (stocks, bonds or cash equivalents) for the benefit of the shareholder. Additionally, mutual funds should not be forced to distribute capital gains to their shareholders, which create burdensome and often unexpected tax consequences for individual mutual fund shareholders.

[5] Sources: U.S. Congressional Budget Office. "CBO Memorandum: The Contributions of Mutual Funds to Taxable Capital Gains." Washington, DC: October 1999. Page 1. Also, Investment Company Institute.

# III. DEMOGRAPHIC CONSIDERATIONS

A review of the data shows that many millions of Americans would benefit from a deferral in the taxation of unrealized capital gains associated with mutual funds. Almost 78 million individuals, comprising over 49 million households (or 48.2% of all U.S. households), owned equities in early 1999.[6] Of those families owning equities, 38 percent owned both stocks and stock mutual funds, 15 percent owned only individual stocks and 47 percent owned only stock mutual funds.[7]

**U.S. Household Ownership of Equities in 1999**

| | Percent of all U.S. Households | Number of Households (millions) | Number of individual investors (millions) |
|---|---|---|---|
| **Any type of equity (net)** | 48.2 | 49.2 | 78.7 |
| Any equity inside employer-sponsored retirement plans | 31.8 | 32.5 | 52.0 |
| Any equity outside employer-sponsored retirement plans | 35.5 | 36.3 | 61.6 |
| **Individual stock (net)** | 26.1 | 26.7 | 40.0 |
| Individual stock inside employer -sponsored retirement plans | 10.5 | 10.7 | 14.0 |
| Individual stock outside employer-sponsored retirement plans | 21.4 | 21.9 | 32.8 |
| **Stock mutual funds (net)** | 40.9 | 41.8 | 66.8 |
| Stock mutual funds inside employer-sponsored retirement plans | 27.9 | 28.5 | 39.9 |
| Stock mutual funds outside employer-sponsored retirement plans | 27.2 | 27.8 | 44.4 |

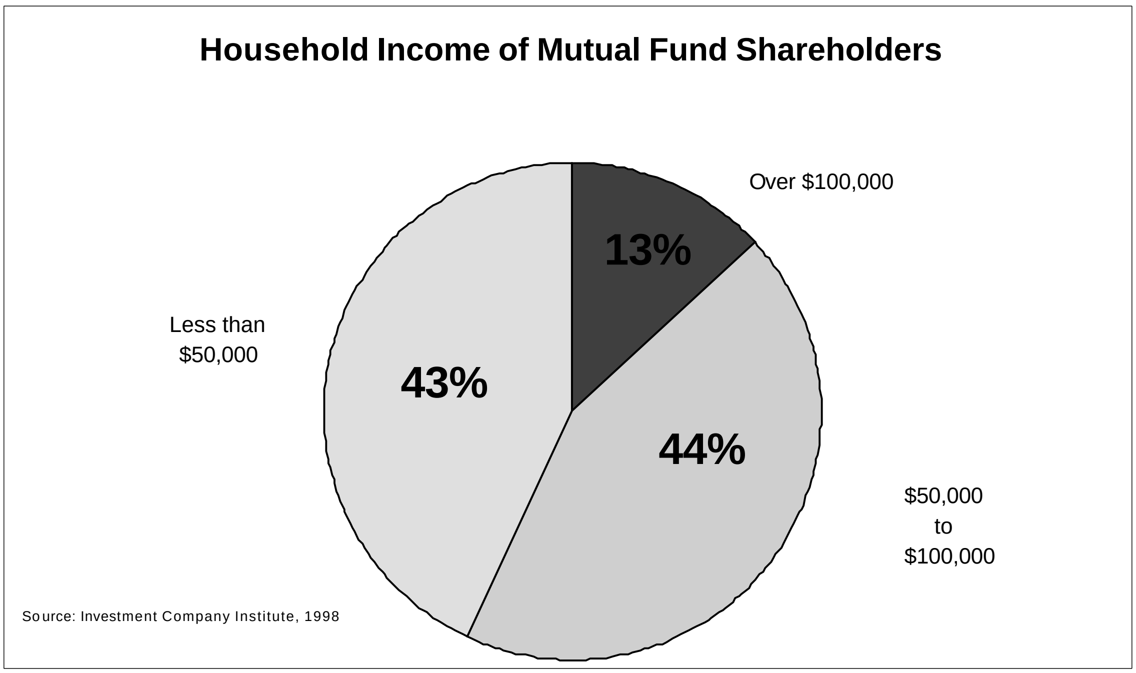
"Equity Ownership in America," Fall 1999, Investment Company Institute and the Securities Industry Association
Figure 12, page 13

[6] Investment Company Institute and the Securities Industry Association. "Equity Ownership in America." Washington, DC: Fall 1999. Page 5.

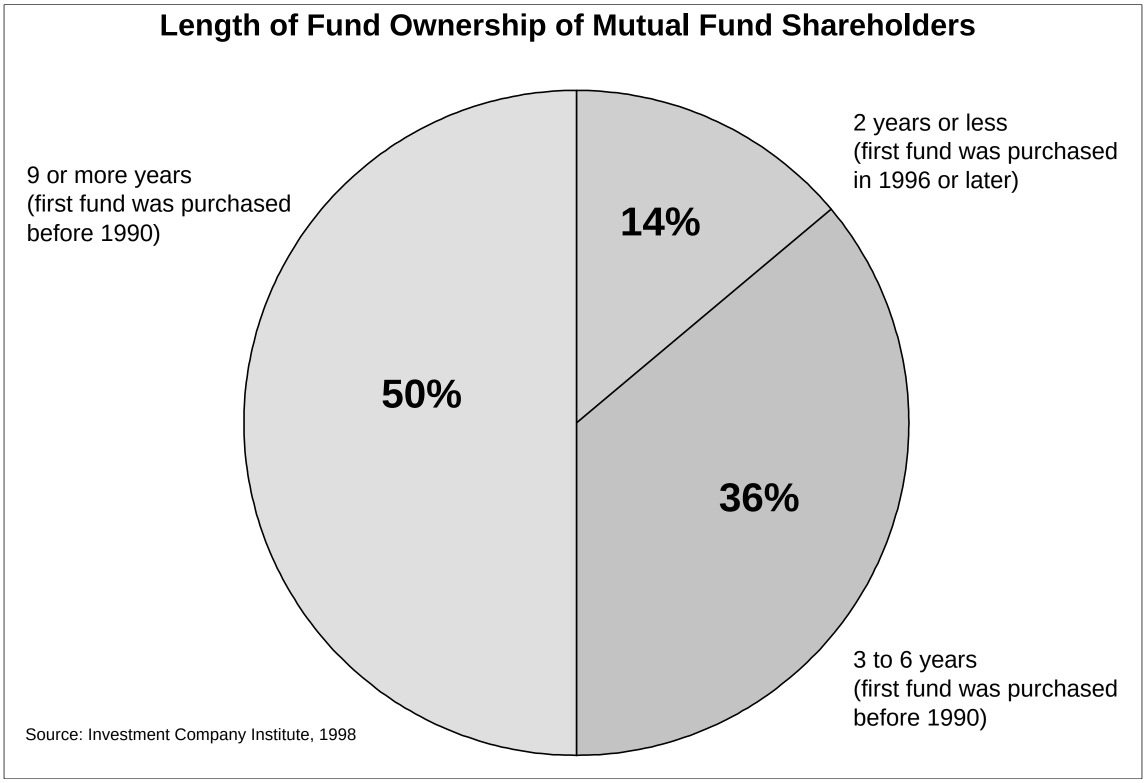
[7] *Ibid*., page 5.

According to the Investment Company Institute (ICI), as of 1998, 87 percent of households that owned shares in mutual funds had an annual household income under $100,000. More importantly, 43 percent of households that own mutual funds have an annual household income less than $50,000.

A change in the tax treatment of mutual funds as proposed 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.



Additional information from the ICI shows that many mutual fund shareholders entered the mutual fund market nine or more years ago. This implies that investors of mutual funds primarily are saving for the future, not engaging in tax avoidance or day-trading behavior. In fact, 75 percent of respondents who own mutual funds outside of employer-sponsored plans indicated that their primary financial goal was to save for retirement.[8]




The amount of assets held in mutual funds has increased dramatically over the past few years. From 1994 to 1998, individually held assets in mutual funds have increased over 138 percent from $1.265 trillion in 1994 to $3.021 trillion. Additionally, over half of all mutual fund assets are held by individuals.

[8] Investment Company Institute. "1998 Profile of Mutual Fund Shareholders." Washington, DC: Summer 1999. Figure 51, page 80.

| Institutional Markets For All Mutual Funds | | | | | |
|---|---|---|---|---|---|
| Assets (in billions) | 1994 | 1995 | 1996 | 1997 | 1998 |
| Individual | $1,265<br>58.50% | $1,602<br>56.80% | $1,955<br>55.40% | $2,442<br>54.70% | $3,021<br>54.70% |
| Institutional | $897<br>41.50% | $1,219<br>43.20% | $1,571<br>44.60% | $1,571<br>45.60% | $2,504<br>45.30% |

Source: Investment Company Institute, 1998

* Institutional assets invested in mutual funds in 1998 amounted to $2.5 trillion, representing 45.3% of all mutual fund assets. The remaining 54.5% of mutual fund assets represent investments of individuals. Institutions include fiduciaries (banks and individuals serving as trustees, guardians, and administrators), business organizations (including corporations, retirement plans, insurance companies, and other financial instituions), nonprofit organizations, and other institutional investors.

As the assets of mutual funds have increased, so has the amount of capital gain distributions that have been distributed to shareholders -- from a 1990 low of $8 billion to a 1997 high of $184.1 billion. In this time period, capital gain distributions by mutual funds have increased a sharp 2,201 percent.

**Capital Gain Distributions to Shareholders**
**All Types of Mutual Funds**
(billions of dollars)

| Year | Equity, Hybrid and Bond Funds |
|---|---|
| 1990 | 8.0 |
| 1991 | 13.9 |
| 1992 | 22.1 |
| 1993 | 35.9 |
| 1994 | 29.7 |
| 1995 | 54.3 |
| 1996 | 101.1 |
| 1997 | 184.1 |
| 1998 | 166.0 |

Source: Investment Company Institute

This dramatic increase in the dollar amount of forced capital gain distributions has caused the average American family to be hit with a sizeable tax liability, even if they did not sell shares in their mutual fund. According to calculations by the Congressional Budget Office (CBO) based on ICI data tabulations, traditionally-held individual mutual fund accounts (not including IRAs or pensions which defer taxation) distributed $50.81 billion in capital gains in 1997.[9] This amounts to 27.6 percent of the $184.1 billion in total capital gain distributions by mutual funds.

# IV. 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.

For example, *Business Week* ran a special report titled "Mutual Funds: What's Wrong," that highlighted some of the economic consequences of forced distributions. "The 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..."[10] Another article states that "…it's common for a stock fund's after-tax return to be 15 percent to 20 percent less than its pretax return."[11]

For a shareholder portfolio that starts out with $10,000 in the first year and returns 10 percent a year before taxes, a 2.3 percentage point reduction in pre-liquidation return would amount to $4,940 over 10 years, $23,188 over 20 years and a $81,924 over 30 years. According to the Investment Company Institute, the median value of stock mutual funds held outside of employer-sponsored retirement plans in 1999 was $26,000.[12] Assuming the same 10 percent rate of return, the same 2.3 percentage point reduction would amount to $12,845 over 10 years, $60,288 over 20 years and $213,002 over 30 years!

Another article points out the confusion mutual fund investors face when they have to calculate their cost basis (the average cost they paid for their shares).[13] The average cost basis needs to include reinvested dividends and capital gains -- the same

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[9] U.S. Congressional Budget Office. "CBO Memorandum: The Contributions of Mutual Funds to Taxable Capital Gains." Washington, DC: October 1999.

[10] Jeffrey Laderman and Amy Barrett. "Mutual Funds: What's Wrong." *Business Week*. January 24, 2000. Page 72.

[11] Leonard Wiener. "The Best-Laid Tax Plans Can Falter When Gains Soar." *U.S. News & World Report*. January 24, 2000. Page 68.

[12] Investment Company Institute and the Securities Industry Association. "Equity Ownership in America." Washington, DC: Fall 1999. Page 43.

[13] Kathy Jones. "Easy Pickin's." *Kiplinger's*. February 2000. Pages 84-87.

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 the rate of return to shareholders and relieve many 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.

# V. POLICY ALTERNATIVES

In order to increase the incentives for the average American to save and invest for the future, it is recommended that the realization point that triggers a capital gains tax liability be changed from the corporate level (for companies such as mutual funds) down to the shareholder level. This would create a more equal tax treatment between investments in mutual funds and investments in direct stock ownership.

A potential tax avoidance scheme could be unintentionally created if this proposal became legislation, without some measures of anti-abuse language. Since mutual funds would be able to trade securities without incurring a tax liability for their shareholders, an incentive would exist for wealthy individuals to form their own "mutual fund." This would allow them to diversify and trade securities without incurring a tax liability until the individuals redeemed their shares in their own created "mutual fund."

Therefore, parallel with changing the tax treatment of unrealized capital gains, it is suggested that anti-abuse language be drafted in legislation that would concretely define the investment companies that would be eligible for this change in tax treatment (e.g., a mutual fund as an entity that is a vehicle for a large number of small investors to pool their risks in order to diversify and secure good investments). This anti-abuse language may necessitate the minimum number of investors required to be considered for this change in tax treatment or individual asset ceilings.

The Internal Revenue Code already provides a definition of a "publicly offered regulated investment company." Specifically, section 67(c)(2)(B) defines a "publicly offered" fund as one the shares of which are (a) continuously offered pursuant to a public offering, (b) regularly traded on an established securities market, or (c) held by or for no fewer than 500 persons at all times during the taxable year.

Additionally, due to the increasing amount of revenue received by the U.S. Treasury associated with capital gains taxes, it may be necessary to place a cap on the amount of capital gains that can be deferred each year to minimize the revenue loss to the government. For simplicity reasons, it is suggested that the ceiling be set equal to $2,500 for single tax filers and $5,000 for joint tax filers. This would reduce the revenue cost as well as insure that the benefits from changing the realization point of taxation of capital gains would primarily go to low- and middle-income investors.

# VI. CONCLUSION

Tax policies are often evaluated based on three criteria: efficiency, equity and simplicity. An efficient tax policy is defined as a policy that raises the most amount of revenue while causing the least distortion in consumer behavior absent the tax. Equity implies that a tax policy should tax people with similar incomes and circumstances the same. Tax simplicity suggests that tax policy be simple to understand and comply with, or reduce the complexity of an existing tax policy.

Changing the tax treatment of unrealized capital gains so that the point of realization that triggers a capital gains tax liability is moved from the corporate level to the individual level is efficient, equitable and simple.

In the long run, changing the realization point of capital gains taxation from the corporate level to the individual level will increase economic efficiency by increasing the returns shareholders will receive on their investment. Additionally, in the long run, an increase in investor returns would likely result in an increase in tax revenue to the government. Hence, both individual investors and the U.S. Treasury would benefit from this tax change. Lastly, this proposed tax change would move toward more equal tax treatment between investments in mutual funds and investments in direct stock ownership.

Mutual funds have increasingly become an important vehicle for low- and middle-income households to invest in the stock market and save for the future. Changing the realization point of capital gains taxation from the corporate level to the individual level is equitable and fair since shareholders of mutual funds are primarily affected by the current tax treatment of unrealized capital gains.

Although a change in the tax treatment of mutual funds would have a beneficial impact on all owners of mutual funds, the benefits would primarily help those making less than $100,000 a year, low- and middle-income investors, with 43% of households owning mutual funds earning less than $50,000 a year.

The forced distribution of a capital gains tax liability by regulated investment companies onto individual shareholders increases the complexity taxpayers must confront when filing their yearly income tax returns. Changing the realization point of capital gains taxation may make it easier for taxpayers to figure out their cost-basis when they redeem their shares for cash. This change may also help to reduce the instances where taxpayers pay more in tax than necessary because of failure to adjust their cost-basis for reinvested capital gains.

This treatment is a type of capital gains rollover. As the current Clinton Administration U.S. Treasury Deputy Assistant Secretary for Tax Analysis Leonard Burman states with respect to rollover of gains in general: "Advocates of this approach argue that the tax code should distinguish between sales of assets to finance consumption and sales in which the proceeds are reinvested. It might also be argued that this option is a natural extension of the realization principle of taxation: that is, tax is due only when the owner of an asset has exchanged it for cash."[14] As Burman also states: "Deferral reduces the effective tax rate on assets that pay returns in the form of capital gains much more than on income-producing assets. Because the tax can be deferred, the money that would have gone to pay taxes can continue to earn returns until the tax is paid."[15]

The current tax treatment of taxing reinvested capital gains of regulated investment companies causes the average mutual fund investor between 10 percent and 20 percent a year in lost return. On a $10,000 investment earning a 10 percent annual rate of return, a 2.3 percentage point reduction in the rate of return would cost a mutual fund investor $81,924 over a 30 year period. With the same rates of return on a $26,000 investment, the median value of stock mutual funds held outside of employer-sponsored retirement plans in 1999, the loss would amount to $60,288 over 20 years and an incredible $213,002 over 30 years!

In order to increase the incentives for the average American to save and invest for the future, it is recommended that the realization point that triggers a capital gains tax liability be changed from the corporate level (for companies such as mutual funds) down to the shareholder level.

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[14] Leonard Burman. *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*. Washington, DC: The Brookings Institution, 1999, page 136.

[15] *Ibid*., page 48.

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