Submission of

The Investment Company Institute

To

The President's Economic Recovery Advisory Board

October 15, 2009

Submitter Category:
Association

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The Investment Company Institute,[1] the national association of investment companies, is pleased to submit these comments to the President's Economic Recovery Advisory Board ("PERAB") in response to the PERAB Tax Reform Subcommittee's September 24 request. This statement addresses the tax system's unnecessary complexities and burdens that affect mutual funds and over 90 million individuals who invest in them. Tax reform should foster long-term savings by making it easier for mutual fund investors to meet their savings goals for long-term needs such as retirement and education. Further, tax reform should simplify the Code by improving rules that create inefficiencies and needless compliance costs for U.S. companies and should address regulatory barriers that prevent U.S. companies from competing globally.

This statement is divided into two sections. The first addresses complexities and burdens affecting all mutual funds and their shareholders. Specifically, the Institute recommends: (1) eliminating uncertainties about the applicability of future tax laws by making permanent the current maximum tax rates on long-term capital gains and qualified dividend income; (2) encouraging long-term savings by deferring the tax on mutual fund long-term capital gain distributions that are reinvested automatically; (3) modernizing tax provisions that inhibit U.S. mutual funds' ability to compete globally; and (4) modernizing outdated or redundant tax rules that impose inefficiencies and unnecessary compliance costs on funds and their shareholders.

The second section of this statement specifically addresses issues with respect to retirement savings vehicles such as 401(k) plans and individual retirement accounts ("IRAs"). With regard to these vehicles, the Institute recommends: (1) making it easier for employers to offer workplace savings arrangements, while preserving the successful voluntary system of employer-based qualified plans; (2) simplifying eligibility rules for IRAs; and (3) relaxing the rules requiring the mandatory distribution of 401(k) and IRA retirement savings at age 70 and a half.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $11. 2 trillion and serve over 93 million shareholders.

I. Issues Affecting All Mutual Funds and Their Shareholders

A. Eliminate Uncertainties for Savers by Making Current Rates Permanent

Doubts about the future applicability of current tax laws, including tax rates, greatly complicate the savings strategies of American families. Individuals and families planning for their retirement years cannot meaningfully project savings goals without a reliable sense of the tax treatment that will be applied both to savings throughout their working lives and to distributions as they enter retirement. Uncertainty on these points undermines the important policy objectives of these laws and inhibits the growth of individual savings and financial predictability and security.

The temporary nature of the maximum tax rates on long-term capital gains and qualified dividend income, which are set to expire after 2010, exacerbates these concerns. Giving permanence to the current rates would reduce for taxpayers the complexity and confusion of the tax laws. More importantly, taxation of investment earnings hinders savings and economic growth. Keeping the maximum tax rate on long-term capital gains and qualified dividend income low would encourage long-term economic growth and protect millions of American families who are struggling to save for their futures.

B. Encourage Long-Term Savings by Deferring Current Taxation of Reinvested Mutual Fund Capital Gain Dividends

Under present law, mutual funds are required to distribute each year their net capital gains. Mutual fund investors typically choose to reinvest automatically any capital gain distributions they otherwise would receive from the fund. Investors with taxable accounts are required to pay taxes on these capital gain distributions even though they take no action to realize these gains. Every year, mutual fund investors perceive unfairness in being taxed on reinvested gains now rather than when they sell their shares.

Legislation strongly supported by the Institute - the Generate Retirement Ownership Through Long-Term Holding Act of 2009 ("the GROWTH Act") - would address this problem by deferring tax on automatically reinvested capital gain distributions until fund shares are sold.[2] Under the GROWTH Act, the reinvested gains would compound, untaxed, in the fund, and tax on the fund's gains would be paid by an investor when the investor decided to redeem the shares and incur the gain.

By reducing current tax bills and allowing earnings to grow tax-deferred, the GROWTH Act would boost long-term savings. The Act also would help address problems for foreign investors in U.S. funds who incur tax currently in their home countries that would not be incurred if they invested

[2] The GROWTH Act was introduced in the Senate (S. 1082) on May 20, 2009, and the House of Representatives (H.R. 3429) on July 30, 2009. Both bills, as in the last Congress, have garnered bipartisan support.

instead in non-U.S. funds. Many European funds are not required to distribute currently their income and capital gain; this income is taxed only when investors redeem their fund shares, making U.S. funds less attractive to those investors. Adopting the GROWTH Act's approach would encourage the long-term savings behavior in the U.S. that so many other Code provisions are intended to promote, and would enhance U.S. funds' ability to compete with non-U.S. funds.

C. Enhance the Global Competitiveness of the U.S. Industry

Global competition also has highlighted the need to modernize the tax rules applicable to funds. The U.S. industry today is the world's strongest. Our ability to compete with foreign funds for foreign investors, however, is hampered by two U.S. tax burdens that apply uniquely to U.S. funds.

First, U.S. withholding tax may be imposed on foreign investors in U.S. funds when such tax is not imposed on the foreigners who invest in the same underlying investments either directly or through foreign funds. For example, foreign investors who receive distributions directly from foreign investments are not subject to U.S. withholding tax. In comparison, foreign investors who receive distributions from the same underlying foreign investments through a U.S. mutual fund are subject to U.S. withholding tax. This inconsistency discourages investment by foreigners into U.S. mutual funds.

Second, foreign investors in U.S. funds often pay tax currently in their home countries on the funds' earnings (because U.S. funds are required to distribute substantially all of their income each year) when the same investments made through foreign funds are not taxed currently in the investors' home countries.[3] Modernizing these tax rules would enhance significantly the U.S. industry's ability to compete in the global marketplace.

D. Modernize the Tax Rules Applicable to Funds

The tax rules applicable to funds should be modernized to reflect changes in securities laws, tax rules of general applicability, investment strategies, and investor preferences. The first tax rules that applied specifically to funds (that qualify for treatment as regulated investment companies) were enacted in 1936. At that time, no comparable fund-specific securities laws existed to regulate the fund industry – an industry that bears very little resemblance to the dynamic force for savings that exists today. Significant changes have occurred during the intervening years, including the enactment of the Investment Company Act of 1940, which provides the framework for regulating funds and protecting fund investors, investor acceptance of new investment products and strategies, and new structures for distributing fund shares to diverse groups of shareholders.

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[3] As discussed above, many foreign funds do not distribute their income and capital gains, and investors in these funds are not taxed until they sell their fund shares. The GROWTH Act would resolve this discrepancy with respect to long-term capital gains.

These developments in the law and the industry have made many existing tax rules redundant and outdated, imposing inefficiencies and needless compliance costs on funds and their shareholders and creating traps for the unwary. Inadvertent failures to satisfy these rules can impose substantial tax penalties directly on funds and, indirectly, on their shareholders. Meaningful tax reform should simplify the Code by eliminating these unnecessary provisions.

II. Issues Related to Retirement Savings Vehicles

A. Encourage Employers to Offer Retirement Plans

The employer-based retirement system, which the Code has for generations nurtured and incentivized, has helped millions of Americans build retirement savings to supplement Social Security. An important and continuing goal of policymakers is to find ways to get more employers to offer workplace retirement plans and more employees to utilize them. The public policy debate should be focused on making it easier for employers to offer retirement arrangements and for workers to start and keep saving. This reform must recognize that employers that do not offer plans tend to have workforces that are less likely to value and utilize retirement savings arrangements because they may be focused on saving for other important goals or may have lower lifetime income (and therefore Social Security will replace a higher proportion of their working earnings). We must also ensure that reforms preserve the existing and successful voluntary employer-based system of qualified plans.

B. Simplify IRA Eligibility Rules to Promote Savings

Retirement security depends in large part on what families are able to save in order to supplement Social Security and any job-based pension that family members might earn. Yet, complicated rules governing income eligibility for IRAs confuse workers and thereby inhibit savings.

IRA eligibility rules are so complicated that even individuals eligible to make deductible IRA contributions often are discouraged from doing so. When Congress imposed the current income-based eligibility criteria in 1986, IRA contributions declined dramatically, even among those who remained eligible for the program. Simpler IRA rules are needed to remove the headaches and complexity individuals perceive in the current tax system, and to promote the retirement savings that such accounts were intended to facilitate.

C. Relax Retirement Account Distribution Rules to Increase Flexibility in Managing Savings

Complicated rules that force older Americans to take required minimum distributions ("RMDs") from retirement plans and IRAs cause significant confusion (*e.g.,* distributions begin after attaining age 70½) and deplete long-term savings. Research shows that that, by and large, people act responsibly with their defined contribution plan account balances at retirement and are responsible stewards of their IRA assets (which often contain significant rollover amounts from employment-based

plans).[4] In fact, retirees tend to preserve these accounts in retirement until the government *forces* a distribution. We can do a better job giving workers flexibility to manage their assets in retirement. One option is to increase the age at which distributions must begin from age 70 ½ to, for example, age 75. This change would not only remove an unnecessary complexity, but it also would recognize the demographic shifts that have occurred since the RMD standard was first adopted. The average life expectancy today at age 65 is about four years longer for men, and three years longer for women, than it was in 1962, when the 70 ½ rule was first added to the retirement plan rules as part of the creation of Keogh plans. At the same time, the Social Security normal retirement age has increased, from 65 to 67.

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The Institute appreciates the opportunity to share our views with the Subcommittee and looks forward to the Subcommittee's continued work. We stand ready to discuss our views further and to assist in any way possible. If you have questions, please do not hesitate to contact Paul Schott Stevens, President and CEO of the Institute (202-326-5901), or Karrie McMillan, the Institute's General Counsel (202-326-5815).

[4] See Holden and Schrass, *The Role of IRAs in U.S. Households' Savings for Retirement, 2008*, ICI Fundamentals, vol. 18, no. 1 (Jan. 2009), available at http://www.ici.org/pdf/fm-v18n1.pdf; Sabelhaus, Bogdan, and Holden, *Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring Between 2002 and 2007* (Fall 2008), available at http://www.ici.org/pdf/rpt_08_dcdd.pdf.