CHAPTER 2

Regulation and Taxation of Mutual Funds

Mutual funds and their principal service providers are regulated by the federal government to protect investors and maintain public confidence in the fund industry.

The U.S. Securities and Exchange Commission (SEC) regulates funds according to the provisions of the Investment Company Act of 1940. Funds must also comply with the Securities Act of 1933 when registering their shares publicly, and must provide notice filings to those states in which they intend to offer their shares. In addition, when fund sponsors sell fund shares to the public they are subject to regulation as broker-dealers under the Securities Exchange Act of 1934. Furthermore, fund investment advisers are generally required to register under the Investment Advisers Act of 1940.

The Foundation of Fund Regulation: The Investment Company Act of 1940

The Investment Company Act, enacted on August 23, 1940, set the structure and regulatory framework for the modern mutual fund industry. The 1940 Act has stood the test of time because of its wide-ranging provisions, which impose restrictions not only on mutual funds but also fund investment advisers, principal underwriters, directors, officers, and employees. Perhaps equally important, the 1940 Act grants the SEC broad discretionary powers to keep the Act current with the constantly changing financial service industry environment in which mutual funds and other investment companies operate.

Taxation, Tax Exemption, and Tax Deferral

Unlike most corporations, a mutual fund generally distributes all of its earnings each year and is taxed only on amounts it retains. This specialized "pass-through" tax treatment of mutual fund income and capital gains was established under the Revenue Act of 1936 and endures today under

Subchapter M of the Internal Revenue Code of 1986. To qualify for this favorable tax treatment under the Code, mutual funds must meet, among other conditions, various investment diversification standards and pass a test regarding the source of their income. Fund investors are ultimately responsible for paying tax on a fund's earnings, whether or not they receive the distributions in cash or reinvest them in additional fund shares.

For more information on tax issues affecting mutual fund shareholders, visit the Institute's policy website at www.ici.org/issues/tax/index.html.

Four Principal Securities Laws Govern Mutual Funds

The Investment Company Act of 1940 regulates the structure and operations of mutual funds and other investment companies. Among other things, the 1940 Act requires mutual funds to maintain detailed books and records, safeguard their portfolio securities, and file semiannual reports with the U.S. Securities and Exchange Commission (SEC).

The Securities Act of 1933 requires federal registration of all public offerings of securities, including mutual fund shares. The 1933 Act also requires that all prospective investors receive a current prospectus describing the fund.

The Securities Exchange Act of 1934 regulates broker-dealers, including mutual fund principal underwriters and others who sell mutual fund shares, and requires them to register with the SEC. Among other things, the 1934 Act requires registered broker-dealers to maintain extensive books and records, segregate customer securities in adequate custodial accounts, and file detailed, annual financial reports with the SEC.

The Investment Advisers Act of 1940 requires federal registration of all investment advisers to mutual funds. The Advisers Act contains various antifraud provisions and requires fund advisers to meet recordkeeping, reporting, and other requirements.

For links to these and other major federal securities laws, visit the Institute's policy website at www.ici.org/issues/ref_federal_statutes.html.

Types of Distributions

Mutual funds make two types of taxable distributions to shareholders: ordinary dividends and capital gains. Dividend distributions come primarily from the interest and dividends earned by the securities in a fund's portfolio and net short-term gains, if any, after expenses are paid by the fund. These distributions must be reported as dividends on an investor's tax return. Capital gain distributions represent a fund's net gains, if any, from the sale of securities held in its portfolio for more than one year. When gains from these sales exceed losses, they are distributed to shareholders. Beginning in 2001, distributions of capital gains on assets held by the fund for more than five years were eligible for treatment as "qualified five-year gains"—taxable at an 8 percent rate—to those investors otherwise taxed on these gains at a 10 percent rate.

To help mutual fund shareholders understand the impact that taxes can have on the returns generated by their investments, the SEC adopted a rule that requires mutual funds to disclose standardized after-tax returns for one-, five-, and 10-year periods. After-tax returns, which accompany before-tax returns in fund prospectuses, are presented in two ways:

- after taxes on fund distributions only (pre-liquidation); and
- after taxes on fund distributions and an assumed redemption of fund shares (post-liquidation).

Share Sales and Exchanges

An investor who sells mutual fund shares usually incurs a capital gain or loss in the year the shares are sold; an exchange of shares between funds in the same fund family also results in either a capital gain or loss (see *Tax-Deferred Retirement Accounts* on page 20 for exceptions to these rules).

Investors are liable for tax on any capital gain arising from the sale of fund shares, just as they would be if they sold a stock, bond, or any other security. Capital losses from mutual fund share sales and exchanges, like capital losses from other investments, may be used to offset other gains in the current year and thereafter.

The amount of a shareholder's gain or loss on fund shares is determined by the difference between the "cost basis" of the shares (generally, the purchase price for shares, including those acquired with reinvested dividends) and the sale price. Many funds provide cost basis information to shareholders or compute gains and losses for shares sold.

Tax-Exempt Funds

Tax-exempt bond funds pay dividends earned from municipal bond interest. This income is exempt from federal income tax and, in some cases, state and local taxes as well. Tax-exempt money market funds invest in short-term municipal securities and also pay exempt-interest dividends.

Even though income from these two types of funds is generally tax-exempt, investors must report it on their income tax returns. Tax-exempt mutual funds provide investors with this information in a year-end statement, and they typically explain how to handle tax-exempt dividends on a state-by-state basis. For some taxpayers, portions of income earned by tax-exempt funds may also be subject to the federal alternative minimum tax.

Even though municipal bond dividends and interest may be tax-free, an investor who redeems tax-exempt fund shares may realize a taxable capital gain. An investor may also realize a taxable gain from a tax-exempt fund if the fund manager sells securities during the year for a net gain.

Tax-Deferred Retirement Accounts

Mutual fund investments in certain retirement accounts are tax-deductible and, generally, dividend and capital gain distributions remaining in the accounts accrue tax-deferred until distributed from the account.

In employer-sponsored 401(k) plans, for example, individuals typically contribute pre-tax dollars from their salary to an account in the plan. Similarly, Individual Retirement Account (IRA) contributions may be tax-deductible, depending upon a person's eligibility to participate in an employer-sponsored retirement plan and the individual's adjusted gross income.

Taxes on mutual fund earnings are deferred when they remain in 401(k) plans, IRAs, and other similar tax-deferred accounts, such as 403(b) accounts. Thus, no tax is incurred as a result of dividend and capital gain distributions, or from the sale of fund shares, until the investor takes distributions from the tax-deferred account.

Distributions are treated as income, which is subject to the investor's federal income tax rate at the time of distribution. (Nondeductible or after-tax contributions to these retirement accounts are not subject to taxation at distribution, and distributions from Roth IRAs also may not be subject to taxation at distribution.)

For most investors, distributions from tax-deferred accounts typically begin at or near retirement age, at which time the individual may be in a lower income tax bracket. Investors who receive proceeds from tax-deferred accounts prior to age 59½ may incur a tax penalty in addition to federal, state, and local income taxes.