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Resurrected Bill Aims to Spur Savings Through Tax Cut

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Legislation first proposed four years ago that would defer taxes on mutual funds' reinvested capital gain dividends until the investor redeems the shares has been resurrected.

The Growth (Generating Retirement Ownership Through Long-Term Holding) Act would encourage retirement savings through the use of mutual funds because it would allow investors to reinvest dividends and income and defer payment on capital gains until they sold their holdings, according to a release by Senator Mike Crapo (R-Id.), who co-sponsored the bill with Tim Johnson (D-S.D.). Of course, 401(k) investors are now taxed on the distributions at retirement at the ordinary income rate.

The **Investment Company Institute**, the industry trade group, yesterday endorsed the proposal, stating in a release that it would increase Americans' savings and retirement security.

The Growth Act was first introduced in 2005. Though mutual fund investors in a 401(k) plan or IRA already have a tax deferment, the bill could allow those investors to save more for retirement, says Niels Holch, executive director of the **Coalition of Mutual Fund Investors**.

Investors who also use mutual funds to save for a down payment on a house or to build a college fund would benefit. Currently, those investors are subject to taxes if they fall outside of a qualified retirement savings plan. Ninety-five percent of investors say they use mutual funds for retirement savings and 52% say they invest to reduce their taxable income, while 45% say they invest in mutual funds as a way to save for emergencies, according to the ICI.

"This could go a long way in addressing one of the disadvantages of mutual funds that have existed for a while," says David Hearth, partner at **Paul Hastings**, regarding the potential tax savings.

Mutual funds, especially actively managed funds, face a distinct tax disadvantage when compared to index funds and exchange-traded funds, Hearth says. This is because portfolio turnover, which is fairly constant, triggers capital gains or losses. Index funds, meanwhile, would be subject to taxes when there are redemptions or when the index resets, which normally happens once a year, he says.

"Taxable income from shareholders in mutual funds also comes from interest and dividends from the underlying portfolio holdings," Hearth says. "So [the proposal] would help neutralize the tax disadvantage by deferring those two primary sources of taxes on a buy-and-hold mutual fund investor."

Ideally, the industry would prefer to have all mutual fund investors receive the tax advantage, but opponents may call for limits on who should qualify for the break, Hearth says. This may force funds to devise new transfer agency and tax reporting systems that could be costly, he says. Legislators confronting a huge and expanding deficit also may not be too keen on losing this tax revenue source, he adds.

The fund industry had hopes of seeing this bill passed in 2005. Back then Congress had sponsored a similar measure and the issue was thought to get a boost when Senators Crapo, Johnson and Jim Bunning (R-Ky.) introduced their bill that year. But observers had noted that the $200 billion earmarked by Congress for the damage done by Hurricane Katrina as well as funding for the Iraq war discouraged legislators from passing a tax break.

"We are as deficit challenged now as we were then," Holch acknowledges. But a huge difference between 2005 and now is the national focus on the financial crisis and lawmakers' wanting to be seen as helping individual investors, and this may bode well for the bill's passing, he says.