106TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
106–547

# MUTUAL FUND TAX AWARENESS ACT OF 2000

MARCH 27, 2000.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. BLILEY, from the Committee on Commerce, submitted the following

# REPORT

[To accompany H.R. 1089]

The Committee on Commerce, to whom was referred the bill (H.R. 1089) to require the Securities and Exchange Commission to require the improved disclosure of after-tax returns regarding mutual fund performance, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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AMENDMENT

The amendment is as follows:

Strike out all after the enacting clause and insert in lieu thereof the following:

79–006

**SECTION 1. SHORT TITLE.**

This Act may be cited as the "Mutual Fund Tax Awareness Act of 2000".

**SEC. 2. FINDINGS.**

The Congress finds the following:

(1) Taxes can be the single biggest cost associated with mutual funds. The average stock fund investor has lost up to 3 percentage points of return every year to taxes.

(2) The average portfolio turnover rate for an activity managed (nonindex) fund has increased from 30 percent 20 years ago to almost 90 percent today, and average capital gains distributions of growth funds, per share, have more than doubled in the last 10 years.

(3) If a fund's performance is based mostly on short-term gains, investors can lose a significant part of their return to taxes.

(4) Performance figures that mutual funds generally disclose to their shareholders are net of fees and expenses, but not taxes, and therefore do not represent the impact taxes have on an investor's return.

(5) This disclosure focuses on how much money investors made before taxes, and not on how much money investors actually got to keep.

(6) Improved disclosure of the effect of taxes on mutual fund performance would allow shareholders to compare after-tax returns to raw performance, and would permit the investors to determine whether the fund manager tries to minimize tax consequences for shareholders.

(7) While the mutual fund prospectus details the average annual portfolio turnover rate, the prospectus may not expressly inform shareholders about the impact the portfolio turnover rate has on total returns.

**SEC. 3. IMPROVEMENTS IN DISCLOSURE REQUIREMENTS.**

Within 18 months after the date of enactment of this Act, the Securities and Exchange Commission shall revise regulations under the Securities Act of 1933 and the Investment Company Act of 1940 to require, consistent with the protection of investors and the public interest, improved disclosure in investment company prospectuses or annual reports of after-tax returns to investors.

## PURPOSE AND SUMMARY

H.R. 1089, the Mutual Fund Tax Awareness Act of 2000, requires that the Securities and Exchange Commission (SEC) revise its regulations under the Securities Act of 1933 and the Investment Company Act of 1940 to require, consistent with the protection of investors and the public interest, improved disclosure in investment company prospectuses or annual reports of after-tax returns to investors. These regulations must be issued within 18 months after the date of enactment.

## BACKGROUND AND NEED FOR LEGISLATION

Mutual funds, as a group of investments, are relatively tax efficient, especially when compared with other investment and savings alternatives. For example, while many savings vehicles provide returns that are taxable as ordinary income on a yearly basis, mutual funds generate returns which can be wholly or partially taxed at the more favorable long-term capital gains rates.

Today, Americans have invested trillions of dollars in mutual funds, with about half of this amount in taxable accounts. The SEC requires that the general effect of investing in mutual funds be disclosed to investors in a narrative in a fund's prospectus. Mutual funds must inform investors of the tax consequences to shareholders of buying, holding, exchanging, and selling fund shares including, as applicable, specific disclosures that distributions from the fund may be taxed as ordinary income or capital gains, that distributions may be subject to tax whether they are received in cash or reinvested, and that exchanges for shares of another fund will be treated as a sale of the fund's shares and subject to tax. Further, funds which may engage in active and frequent trading of portfolio securities also are required to explain the tax consequences of increased portfolio turnover, and how this may affect a fund's performance.

Mutual funds are also required to list past performance figures in a fund's prospectus. Such performance figures are disclosed to shareholders net of fees and expenses, but not taxes. This means that listed performance figures do not take into account the impact taxes have on an investor's rate of return. Instead, disclosure focuses on how much money investors made before taxes, but not how much money investors actually got to keep.

Mutual fund shareholders invested in taxable funds are taxed on their investments in two ways. First, when funds distribute income and net realized gains (whether received in cash or reinvested in additional shares), shareholders are required to pay taxes on those distributions. Second, when the investors redeem their fund shares at a gain (whether received in cash or exchanged for shares in another fund), the investors must pay taxes.

Concerning taxes on distributions, the Internal Revenue Code effectively requires a mutual fund to distribute all net income and realized gains from investments on a yearly basis. Such distributions are taxable to shareholders in two ways: (1) Distributions attributable to dividends, taxable interest and net short-term capital gains are taxable to investors as ordinary income; and (2) distributions attributable to net long-term capital gains are taxable as long-term capital gains. In 1998 alone, mutual funds distributed approximately $166 billion in capital gains and $134 billion in taxable dividends.

Most non-index funds experience high portfolio turnovers. The average portfolio turnover rate for an actively managed non-index fund has increased from 30 percent 20 years ago, to 90 percent today. While high portfolio turnover in non-index funds will not necessarily result in higher taxes for investors, in practice it frequently does. Fund managers who turn over their portfolios without considering the tax consequences of their decisions on fund investors may realize gains from the sale of portfolio securities without offsetting losses, resulting in higher yearly taxes for investors.

Taxes are one of the most significant costs of mutual fund investment. Based on calculations using data from Morningstar, the average domestic equity mutual fund has lost nearly two and one-half percentage points per year to taxes on distributions of dividends and capital gains made to the fund's shareholders. In the last five years, it is estimated that investors in diversified U.S. stock funds surrendered an average of 15 percent of their annual gains to taxes. Despite these facts, many individual investors still do not understand how these taxes affect their mutual fund investments, and they do not understand that differences in fund investment strategies can produce markedly different tax consequences.

If every fund lost the same amount to taxes each year, then little useful information would be gained by reporting after-tax returns. However, funds vary tremendously in the tax burdens they place on their shareholders. Performance reporting that considers only pre-tax returns could lead taxable investors to believe that the past performance of a particular fund was much better than it actually was for a taxable shareholder.

One of the fundamental principles underlying securities regulation is that investors should have access to the most accurate information reasonably available concerning the performance of their investments. This is certainly true for mutual funds. Because under present disclosure regulations the impact of ordinary income and capital gains taxes are not included in listed historical performance figures, a potentially inaccurate impression may be created for investors. Investors must be better informed about how much money they get to keep once taxes on returns are taken into consideration. By doing so, investors will be in a better position to choose mutual funds which best suit their investment needs.

During the October 29, 1999 hearing on the bill before the Subcommittee on Finance and Hazardous Materials, witnesses agreed that it was important to provide investors with information concerning after-tax rates of returns for mutual funds. While all witnesses supported the goals of this legislation, they differed on the methodology to be employed by the SEC for reporting after-tax rates of return to mutual fund shareholders.

Joel M. Dickson, Ph.D., of The Vanguard Group, Inc., testified in favor of a methodology which assumes that fund shares are not liquidated at the end of the measurement period. While this pre-liquidation return methodology may understate taxes for those investors who did in fact redeem shares before the expiration of the measurement period, Dr. Dickson preferred this method because it focuses on the effects on all shareholders of the taxes resulting from the portfolio manager's investment decisions. Further, Dr. Dickson testified that the SEC should employ a methodology for computing after-tax rates of return for mutual fund investors which incorporates the highest individual Federal income tax rate in effect at the time of distribution. Dr. Dickson also testified that The Vanguard Group employs a similar methodology in voluntarily providing information about their after-tax rates of return to investors.

David B. Jones, Vice President of Fidelity Management & Research Company, testified that a methodology including post-liquidation returns gives a more realistic impression of a typical investor's after-tax return, especially for longer time periods. Mr. Jones testified that focusing solely on pre-liquidation returns risks fostering the impression that taxes can be deferred indefinitely, and tends to exaggerate the benefits of tax deferral. While Fidelity also voluntarily lists after-tax rates of return for some of their funds, they only list pre-liquidation rates of return in conjunction with post-liquidation return rates.

Given the differing opinions about the correct methodology to be employed in deriving after-tax rates of return for mutual funds, the legislation defers to the SEC about whether to list such returns on a pre- or post-liquidation basis, or both.

The Committee notes that there have been increasing demands for improvement in the disclosure of tax consequences of mutual fund investments. Mutual funds and third party providers are responding to this growing investor demand by providing after-tax information and offering Internet tools that investors can use to compute after-tax returns. Several fund groups have created new funds promoting the use of more tax-efficient portfolio management strategies. The Committee commends these developments but believes that the standardized disclosures called for by this legislation will best help investors understand the magnitude of tax costs and compare the impact of taxes on the performance of different funds.

In response to the Committee's interest in H.R. 1089 and to investor demand for better information about the impact of taxes on mutual fund performance, the SEC on March 15, 2000, issued a proposed rule (Release Nos. 33–7809; 34–42528; IC–24339; File No. S7–09–00) that would require funds to present both pre- and post-liquidation after-tax returns. The Committee expects that, in developing the best methodology for computing after-tax rates of return for mutual funds, the SEC will consider the comments of the industry, investors, and others on this recently issued proposal.

## HEARINGS

The Subcommittee on Finance and Hazardous Materials held a hearing on Increasing Disclosures to Benefit Investors on October 29, 1999. The Subcommittee received testimony from the following witnesses: Joel M. Dickson, Ph.D., Senior Investment Analyst, The Vanguard Group, Inc.; Mr. David B. Jones, Vice President, Fidelity Management and Research Company; and Mr. Matthew P. Fink, President, Investment Company Institute. The SEC submitted written testimony for the hearing record.

## COMMITTEE CONSIDERATION

On November 2, 1999, the Subcommittee on Finance and Hazardous Materials met in open markup session and approved H.R. 1089 for Full Committee consideration, as amended, by a voice vote. On March 15, 2000, the Committee on Commerce met in open markup session and ordered H.R. 1089 reported to the House, amended, by a voice vote.

## COMMITTEE VOTES

Clause 3(b) of Rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. There were no record votes taken in connection with ordering H.R. 1089 reported. A motion by Mr. Bliley to order H.R. 1089 reported to the House, without amendment, was agreed to by voice vote.

The following voice vote was taken on amendments to the bill:

An amendment in the nature of a substitute by Mr. Gilmor, No. 1, making technical changes to the bill, was agreed to by voice vote.

## COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the Committee held a legislative hearing and made findings that are reflected in this report.

### COMMITTEE ON GOVERNMENT REFORM OVERSIGHT FINDINGS

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, no oversight findings have been submitted to the Committee by the Committee on Government Reform.

### NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee finds that H.R. 1089, the Mutual Fund Tax Awareness Act of 2000, would result in no new or increased budget authority, entitlement authority, or tax expenditures or revenues.

### COMMITTEE COST ESTIMATE

The Committee adopts as its own the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

### CONGRESSIONAL BUDGET OFFICE ESTIMATE

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
*Washington, DC, March 23, 2000.*

Hon. TOM BLILEY,
*Chairman, Committee on Commerce,*
*House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 1089, the Mutual Fund Tax Awareness Act of 2000.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contacts are Mark Hadley (for federal costs) and Jean Wooster (for the private-sector impact).

Sincerely,

BARRY B. ANDERSON
(For Dan L. Crippen, Director).

Enclosure.

*H.R. 1089—Mutual Fund Tax Awareness Act of 2000*

CBO estimates that enacting H.R. 1089 would have no impact on the federal budget. Because the bill would not affect direct spending or receipts, pay-as-you-go procedures would not apply. H.R. 1089 contains no new intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act.

H.R. 1089 would require the Securities and Exchange Commission (SEC) to revise regulations to improve the disclosure of information on after-tax returns in investment company prospectuses or annual reports. On March 15, 2000, the SEC proposed a rule to require disclosure of the after-tax returns to investors based on a standardized formula, so the bill would not change the agency's current work plans. Because CBO expects that the rule would be implemented under current law, H.R. 1089 would not impose a new mandate on the private sector.

The CBO staff contacts are Mark Hadley (for federal costs), and Jean Wooster (for the private-sector impact). This estimate was approved by Peter H. Fontaine, Deputy Assistant Director for Budget Analysis.

## FEDERAL MANDATES STATEMENT

The Committee adopts as its own the estimate of Federal mandates prepared by the Director of the Congressional Budget Office pursuant to section 423 of the Unfunded Mandates Reform Act.

## ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

## CONSTITUTIONAL AUTHORITY STATEMENT

Pursuant to clause 3(d)(1) of rule XIII of the Rules of the House of Representatives, the Committee finds that the Constitutional authority for this legislation is provided in Article I, section 8, clause 3, which grants Congress the power to regulate commerce with foreign nations, among the several States, and with the Indian tribes.

## APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of section 102(b)(3) of the Congressional Accountability Act.

## SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

### *Section 1. Short title*

This section provides the short title of the legislation, the "Mutual Fund Tax Awareness Act of 2000".

### *Section 2. Findings*

Section 2 sets forth the findings for this bill.

### *Section 3. Improvements in disclosure requirements*

This section requires the SEC, within 18 months after the date of enactment of this bill, to revise regulations under the Securities Act of 1933 and the Investment Company Act of 1940 to improve disclosure in investment company prospectuses or annual reports of after tax returns to investors. While the bill does not specify a methodology or form for after tax return information, it does direct the SEC to make rules consistent with the public interest and the protection of investors. Although this section requires the SEC to improve disclosure for "investment companies," the Committee intends for improvement to be made for mutual funds (i.e., open-end management investment companies) and not necessarily for other types of investment companies.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

This legislation does not amend any existing Federal statute.

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