

Letter to Treasury Urging Simplified Tax Rules, July 2002

March 22, 2002

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RE: Tax Simplification for Individuals

Dear Rob and Bill:

The Investment Company Institute¹ applauds the Treasury Department's recent initiatives to simplify and rationalize our income tax system, particularly with respect to individual taxpayers. As the national association for the mutual fund industry, we are keenly aware of the difficulties that individuals seeking to achieve important financial goals face when they try to understand and apply our tax laws.

This letter identifies several potential changes to the Internal Revenue Code that would significantly simplify the tax treatment of mutual fund shareholders. We respectfully request that you consider them as part of your comprehensive review of the US income tax system. In particular, we recommend changes that would:

- simplify the taxation of long-term capital gains;
- make permanent the crucial improvements made to long-term savings vehicles in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA);
- repeal the complex income eligibility rules applicable to individual retirement accounts (IRAs)—rules that effectively have deterred many eligible individuals from using these vehicles to save for retirement; and
- simplify the required minimum distribution requirements applicable to retirement plans and IRAs.

1. Reduce confusion and complexity in the taxation of long-term capital gains

As you know, the Institute supports deferring the payment of tax on capital gain dividends that mutual fund shareholders reinvest in additional fund shares, until the shareholders take the affirmative step of selling these shares. The current law tax treatment of reinvested capital gain dividends is counterintuitive to many shareholders. This change would more closely align federal tax law with shareholder expectations that capital gain taxes are not due on an investment until that investment is sold.

We also support modifications that would simplify the general rules for taxing long-term capital gains. While the various rates at which capital gains may be taxed (such as the qualified five-year gain rate) were enacted for tax policy reasons, their proliferation has greatly complicated the IRS Form 1040 Schedule D that is used by taxpayers to calculate tax on their net capital gains. Options

for simplifying the taxation of capital gains include excluding from taxable gains a specified percentage of long-term capital gains or taxing all long-term capital gains at one rate. Either approach would significantly shorten and simplify Schedule D.

2. Make permanent the crucial improvements made to long-term savings vehicles in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)

EGTRRA included several important enhancements to our nation's pension laws² and improved incentives for education savings vehicles (such as Code section 529 qualified tuition programs and Coverdell education savings accounts).³ Absent further Congressional action, however, all of these important changes will cease to apply after December 31, 2010. The ability of Americans to save for retirement and education could be greatly simplified if these provisions were made permanent. For individuals to plan appropriately for their retirement and other long-term needs, they must be able to rely on predictable rules—rules that apply now and throughout one's career and retirement. The future termination of these provisions could affect the long-term savings strategies of working individuals, undermining the purpose of these reforms. To eliminate this uncertainty, these EGTRRA improvements to the retirement and education savings systems should be made permanent as soon as possible.

3. Repeal the complex income eligibility rules applicable to IRAs

The rules governing IRAs should be simplified by eliminating the phase-out income eligibility restrictions for IRA contributions and eliminating the income limits on the eligibility to make deductible IRA contributions. Such simplification would address an important need: the current IRA eligibility rules are so complicated that even individuals eligible to make deductible IRA contributions are often deterred from doing so.

When Congress imposed the current income-based eligibility criteria in 1986, IRA participation declined dramatically—even among those who remained eligible for the program. Fifteen years later, surveys find, many individuals continue to be confused by the IRA eligibility rules. This confusion is an important reason behind the decline in contributions to IRAs from their peak in 1986. For these reasons, the Institute strongly supports repeal of the IRA's complex eligibility rules, which serve to deter lower- and moderate-income individuals from participating in the program.

4. Simplify the required minimum distribution requirements

The Institute also supports efforts to simplify the required minimum distribution (RMD) rules applicable to retirement plans and IRAs⁴. In particular, we support the Joint Committee on Taxation's recent suggestion that no minimum distribution be required during the life of a participant. As the Joint Committee notes, however, appropriate rules would be needed to ensure taxation of the undistributed accrued benefit. While we have some concerns about the unintended consequences of the Joint Committee's approach for taxing the participant's heir on the undistributed accrued benefit,⁵ the Institute supports the overall effort to further simplify the RMD rules.

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If the Institute can provide you with any additional information, or respond to any questions you may have, regarding the suggestions made in this letter, please do not hesitate to contact me at 202/326-5832. Thank you.

Sincerely,

Keith Lawson
Senior Counsel

ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 9,039 open-end investment companies ("mutual funds"), 486 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.951 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

² Among the numerous improvements made to the private retirement system, the legislation: (a) increased the contribution limits to IRAs and employer-sponsored retirement plans, (b) provided for "catch-up" contributions to be made by individuals 50 and over to their pension plans and IRAs, and (c) made retirement assets significantly more portable, especially among different types of retirement plans.

³ EGTRRA provisions relating to 539 plans, among other things, (1) exclude distributions used for qualified higher education expenses from gross income, (2) replace the current state-imposed “more than a de minimis penalty” on nonqualified distributions with a federal 10 percent tax, (3) permit rollovers of amounts between 529 programs for the same beneficiary, and (4) permit a change in designated beneficiary to “first cousins.” With regard to Coverdell accounts, changes made by EGTRRA included an increase in the annual contribution limit from \$500 per designated beneficiary to \$2,000. These provisions generally became effective on January 1, 2002.

⁴ Under these complex rules, plan participants and IRA owners are generally required to take RMDs from their plans and IRAs after reaching age 70 ½.

⁵ For example, a rule requiring distribution of an entire account balance subject to the RMD rules within five years of the participant’s death could result in harsh tax consequences for the participant’s beneficiaries.