



OPINIONS

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ICI CEO: Washington Should Stop Penalizing Middle-Class Savers

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Mutual funds have long been the investment vehicle of choice for middle-class Americans saving for retirement, college, or homeownership. They are stable, diversified, and well regulated—making them ideal for long-term investment horizons.

Yet these investors face an outdated and unfair tax burden that penalizes their efforts to save. A recently introduced piece of bipartisan legislation, the Generating Retirement Ownership Through Long-Term Holding, or Growth Act, would fix the quirk in the tax code that hits savers with surprise tax bills.

Investors in mutual funds can be taxed on capital gains even if they don't sell a single share. Funds must distribute realized gains each year, and those distributions are taxable—even when they are automatically reinvested.

A shareholder who bought shares late in the year is taxed on capital gain dividends even if those gains were realized before that shareholder's entrance. In other words, investors can owe taxes on income they never received and on gains they never realized.

This isn't how we treat other types of investments: If you buy and hold a stock, real estate, or another asset, you pay capital-gains tax only when you sell. But mutual fund investors can be taxed simply because the fund's manager bought or sold securities in the normal course of running the fund. We are imposing a tax on professional portfolio management—on buying and selling certain securities based on an investment strategy, which is a key benefit of owning a fund for retail investors.

The resulting “phantom tax” blindsides middle-income households that think they are doing everything right: saving diligently, reinvesting earnings, and sticking to a long-term investment plan.

Nearly 40 million Americans own mutual funds in taxable accounts, according to the Investment Company Institute's Annual Mutual Fund Shareholder Tracking Survey. More than half of those 23 million households earn less than \$150,000 a year. It is middle-class

families, not the wealthy, who bear much of the burden of this absurd piece of the tax code.

Research shows just how costly these phantom taxes can be. For a mutual fund tracking the value of the S&P 500 index, taxation of capital-gain distributions effectively reduced the rate of return by as much as 0.5% per year over the past 20 years. Our research at the ICI indicates that Americans investing in 2005 would have 8.4% less accumulated returns today based on annual capital gains distributions of equity mutual funds over the past two decades.

Middle-class investors can even be hit with tax bills when their holdings decline in value. Consider an investor who puts \$10,000 into a mutual fund. During the year, the fund realizes \$1,000 in long-term capital gains per shareholder, which the holder reinvests in the fund. After broader market declines, the account is worth \$8,500 at year's end. Even though the investor ended up with less than at the start, he or she still owes about \$150 in taxes, if he or she falls within the 15% capital-gains tax bracket. Out \$1,500 on paper and still writing a check to the Internal Revenue Service.

The Growth Act would fix this problem.

The bill would allow mutual fund shareholders to defer taxes on capital-gain distributions that are reinvested. Instead of taxing investors every time the fund distributes a gain, even if they reinvested those distributions and never actually sold their shares, the tax would be deferred until the investor actually sells shares. This means that mutual fund shares would be taxed the same as other buy-and-hold, long-term investments.

This is a common-sense reform. And, equally important, the government still gets the capital-gains tax revenue when investors actually realize their investment appreciation, making the change revenue-neutral in the long run. Meanwhile, the billions of dollars currently diverted to phantom taxes could instead remain invested in the economy.

By modernizing an outdated provision of the tax code, the Growth Act would restore fairness for millions of middle-class investors who rely on mutual funds in their taxable accounts. These Americans are doing exactly what policymakers say they should: saving for the future in well-regulated, diversified investment vehicles.

Congress should seize the opportunity to support them—not with a handout but by ending a tax penalty that never made sense in the first place.