INVESTMENT COMPANY INSTITUTE®

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The Honorable Orrin Hatch
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Ron Wyden
Ranking Member, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Hatch and Ranking Member Wyden:

The Investment Company Institute[1] (ICI) urges the Finance Committee to strike from the Chairman's Mark of the "Tax Cuts and Jobs Act of 2017" the provision that would require taxpayers to determine the cost basis of securities on a first-in, first-out (FIFO) basis.[2] This provision would increase taxes on middle-income fund investors. It would do so in two ways, because it applies both to the taxpayer's shares in a fund and to the securities held within the fund itself. Further, the proposal would disproportionately harm fund shareholders, would not simplify the tax laws, and would interfere with efficient capital formation.

Mandatory FIFO Could Increase Tax on Fund Shareholders When Fund Shares are Sold

Under current law, taxpayers who have purchased a single security at different times for different amounts can specifically identify which tax lots are sold. This policy recognizes that securities are not fungible for tax purposes. Each lot is a discrete asset with distinct tax attributes, including holding period and unrealized gain or loss. Those attributes can have a significant impact when an investor chooses to sell a specific security. Current law permits taxpayers to choose how and when to utilize those tax attributes.

Many mutual fund shareholders, who typically purchase shares repeatedly (including through dividend reinvestment programs), calculate gain or loss on their redeemed shares using the average cost method. We are pleased that the Chairman's Mark maintains this simplified method of accounting for fund shareholders.

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$20.9 trillion in the United States, serving more than 100 million US shareholders, and US$6.6 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] Section III.G.3 of the Chairman's Mark.

For shareholders who do not use average cost, however, requiring FIFO likely would increase the amount of tax upon redemption by taking away investors' ability to choose which lots to sell. In the context of rising markets, the oldest lots of a security likely have a lower cost basis, resulting in a greater amount of capital gain. Shareholders who have not used average cost probably have used some form of specific identification when redeeming fund shares, either by specifically identifying lots upon each redemption or relying upon a pre-determined instruction to their broker. Thus, they generally would have sold newer, higher-basis shares first, retaining the oldest shares. Requiring FIFO for all future sales would require shareholders to now sell the oldest lots, increasing dramatically the amount of capital gain on each redemption.

Mutual fund shareholders tend to hold their shares for extended periods of time because they have long-term savings goals. Forty-four percent of US households who currently own mutual funds purchased their first mutual fund shares before 1990.[3] Americans invest in mutual funds to save money for retirement, education, and other expenses. Requiring them to sell shares on a FIFO basis would increase the amount of tax that they pay, resulting in significantly less cash for these other needs.

Mandatory FIFO Would Increase Tax to Fund Shareholders When Funds Sell Securities

Requiring the use of FIFO also would hurt fund shareholders even if the shareholders do not redeem shares, because the rule would apply to securities within the fund portfolio. Mutual funds are required under Subchapter M and the excise tax rules under section 4982 to distribute substantially all of their net capital gain to their investors each year. Those distributions are taxable to the fund shareholders. Funds often try to minimize the amount of capital gain that must be distributed, especially if they are selling securities to fund other needs, such as redeeming other shareholders. Under current law, funds can choose which lots of specific securities to sell, minimizing the amount of capital gain recognized and then distributed. FIFO would take away this ability to manage taxable gains and losses within the fund. Again, given that the oldest securities likely would have a lower cost basis, this would increase the amount of capital gain recognized and distributed as taxable capital gain dividends to shareholders.

Mandatory FIFO Would Disproportionately Harm Fund Investors

Although the proposal in the Chairman's Mark does not provide specifics, we assume that the proposal would be similar to that included in the Tax Reform Act of 2014. In that bill, the FIFO provision would have applied on an account-by-account basis. That meant that an investor who held the same security with multiple brokers would not have to apply the FIFO rule across all his or her accounts; rather, the investor would have to sell the oldest lots in the account from which the sale was being made.

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[3] *See* 2017 Investment Company Institute Factbook, p. 119, Figure 6.8. This represents those purchases outside an employer-sponsored plan.

This rule is necessary from an operational standpoint, because it would be impossible to ensure that an investor truly sells the oldest lots first if they are held across multiple accounts. Nevertheless, this rule would allow certain investors to effectively avoid the FIFO requirement by opening multiple accounts with multiple brokers. Investors could then choose to sell from the account with the highest basis lots, reducing their taxable capital gains. Only sophisticated and relatively well-off investors would be likely to take advantage of this rule.

Mutual fund investors, on the other hand, typically would hold only one account with a fund. Most would not have the wherewithal or knowledge to open multiple accounts. Therefore, unlike their wealthier counterparts, they would be required to sell the truly oldest shares first, resulting in higher amounts of taxable capital gain.

Mandatory FIFO Interferes with Efficient Capital Formation

A taxpayer, including a fund, that is required to use FIFO might choose to retain securities that otherwise would be sold. This "lock-in" effect could occur because older lots typically will have a lower cost basis and higher unrealized gain than newer shares. Under current law, the investor might choose to sell securities with a higher cost basis and lower unrealized gain; however, mandatory FIFO would eliminate this flexibility. It thus could prevent the investment of capital elsewhere. Retaining securities that would be sold, but for the tax consequences, reduces optimal portfolio management and market efficiency.

Mandatory FIFO is not a Simplification of Tax Law

Requiring FIFO does not simplify the Internal Revenue Code. As mentioned above, many mutual fund shareholders use the average cost method, which the Senate Mark maintains. For those shareholders who do not use average cost, the Code requires brokers, including mutual funds, to provide to investors and the Internal Revenue Service (IRS) the cost basis of certain securities acquired after December 31, 2010, and fund shares acquired after December 31, 2011.[4]

The financial services industry spent considerable time and money in developing the required cost basis reporting systems. Thus, for securities acquired after 2010 or fund shares acquired after 2011, investors who specifically identify lots do not have to determine the basis of their shares for tax purposes; rather, the broker provides that information to them. Brokers have the systems and capabilities in place to do this and have been doing so for the past 6-7 years. FIFO does not provide necessary simplification for the government, either, as brokers also provide this basis information to the IRS.

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[4] Mandatory cost basis reporting was added to the Code by the Economic Stabilization Act of 2008. Final regulations were issued in October 2010.

Requiring taxpayers to use FIFO when selling securities would increase taxes on middle-income shareholders, disproportionately harm fund investors, undermine efficient capital formation, and would not simplify the tax laws. We thus urge the Finance Committee to delete this provision from the Chairman's Mark. Please do not hesitate to contact me if you would like to discuss these issues further.

Sincerely,

Paul Schott Stevens
President & CEO
Investment Company Institute

cc: Members of the Senate