UNINTENDED CONSEQUENCES OF WYDEN'S PROPOSAL TO CHANGE TAX TREATMENT FOR MUTUAL FUNDS AND ETFS

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On 10 September 2021, Senate Finance Committee Chairman Ron Wyden of Oregon released a discussion draft proposing changes to partnership taxation, and to the taxation of regulated investment companies including mutual funds and exchange-traded funds (ETFs)--that would have significant impacts in the world of investment funds.[1] Much of what is included in the proposed legislation would impose more rigid structures on how income, gains and losses of a partnership can be allocated among its partners. This alert, which is the first in a series, addresses how the proposed changes would impact regulated investment companies.

Mutual funds and ETFs are two types of regulated investment companies that are subject to the same federal income tax rules. Under these rules, when a mutual fund or ETF sells appreciated portfolio securities, including to meet redemptions, it recognizes capital gain that is distributed before year-end to shareholders, who then must pay income tax on the gain distributed at year-end. Alternatively, under section 852(b)(6) of the Internal Revenue Code of 1986, as amended (the Code), mutual funds and ETFs may instead distribute appreciated portfolio securities in-kind to shareholders in redemption of their shares without recognizing gain on the securities.[2] Unlike mutual funds, which generally do not distribute appreciated portfolio securities in kind in redemption of shares, ETFs routinely do distribute securities in-kind to shareholders; and as a result of section 852(b)(6) of the Code, ETFs do not recognize gain on appreciated securities included in the distribution. *Senator Wyden's discussion draft proposes to repeal section 852(b)(6), which would result in mutual funds and ETFs recognizing gain on appreciated securities distributed to shareholders in-kind, increasing the amount of taxable gain that ETFs will distribute to non-redeeming shareholders.*

Shareholders of a mutual fund buy their shares directly from the mutual fund and, when they no longer want the shares, they sell them back to the mutual fund in a redemption transaction. Just like the purchase price, this sale (or redemption) price for their shares is equal to the value of the shares' proportionate interest in the assets of the mutual fund (referred to as net asset value or NAV). In contrast, most shareholders of an ETF (retail shareholders) buy and sell their shares on the stock exchange, where the price is a market price on the exchange.

There is a second category of ETF shareholders, which are securities brokers or dealers (known as authorized participants), who deal directly with the ETF to create and redeem shares in the ETF. Authorized participants contribute baskets of securities in-kind to the ETF in exchange for aggregations of shares (known as creation units), and when they redeem their shares they receive an in-kind distribution of securities equal in value to the NAV of the creation units redeemed. The authorized participants' activities in acquiring securities to purchase creation units and in acquiring ETF shares on the market to redeem creation units establish what is known as the "ETF arbitrage mechanism", which results in the market price for ETF shares closely tracking the shares' NAV.

The ETF arbitrage mechanism results in ETFs regularly disposing of appreciated securities, currently without recognizing taxable gain that must be distributed to shareholders. It is this last point that is the focus of the proposed repeal of section 852(b)(6).

Senator Wyden's discussion points accompanying the draft proposal assert that in-kind redemptions generally result in ETFs making smaller taxable capital gain distributions to their shareholders than do mutual funds. Senator Wyden also claims that ETF shares can appreciate even more, and with less frequent fund-level recognition of gain, than mutual fund shares. An ETF shareholder, however, does not avoid paying taxes on the gain, she merely defers recognizing and paying taxes on the gain until she sells the shares.

While one result of the repeal of section 852(b)(6) would be to cause ETFs to recognize more taxable gain than they do currently, there may be other unintended consequences.

- Twelve million U.S. households own ETFs, and 92% of such households have an annual income of less than $400,000. In fact, the median household income of ETF investors is $125,000 per year.[3] Thus, the proposed tax will affect many U.S. investors with an annual income well below $400,000, even though the administration's stated goal has been limited to raising revenue from households with an annual income of $400,000 or more.[4]

- Section 852(b)(6) plays an important role in mitigating the systemic risk potentially posed by a "run" on mutual funds and ETFs, and the U.S. Securities and Exchange Commission, as the administrator of the federal securities laws, has recognized the potential for in-kind redemptions to mitigate such systemic risk in various rules, including recently adopted rules 6c-11 and 22e-4 under the Investment Company Act of 1940. In this respect, the repeal of section 852(b)(6) may be exactly what the doctor didn't order at a time when Congress and the Administration are seeking to lessen systemic risk in the financial system.

- If section 852(b)(6) were repealed, many of the tax costs associated with authorized participants' short-term trading of ETF shares will be borne by long-term ETF shareholders. Also, the ETF arbitrage mechanism will be burdened by the increased tax costs as such tax costs may be passed back by ETFs to authorized participants in the form of transaction fees, resulting in ETF shares trading at wider bid-ask spreads and discounts to NAV. In the end, retail shareholders will pay these costs in the form of wider bid-ask spreads and market prices that are less than NAV (*i.e.*, a discount to NAV).

- The ETF industry is today a US$8 trillion industry,[5] which employs a commensurate number of people, due in part, to retail investors recognizing the favorable tax treatment applied by section 852(b)(6) to the ETF structure. However, the repeal of section 852(b)(6) could adversely impact the sector.

The repeal of section 852(b)(6) is expected to be included in budget reconciliation legislation being developed in the Senate Finance Committee. Chairman Wyden's stated policy for the proposal is "to close loopholes that allow wealthy investors and mega-corporations to use pass-through entities, primarily partnerships, to avoid paying their fair share of taxes." As discussed above, in attempting to achieve this goal, the proposal may create unintended consequences, particularly for retail investors, that outweigh any perceived benefit of the repeal of section 852(b)(6).

Please contact the authors for information on how to provide input to Congress on this proposal.

FOOTNOTES

[1] Staff of S. Comm. on Finance, 117th Cong., Wyden Pass-through Reform Discussion Draft (Comm. Print 2021).

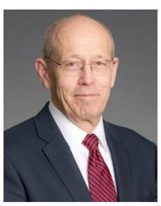
[2] Section 852(b)(6) is an exception to the general rule that a corporation's distribution of property to its shareholders results in the recognition of gain by the corporation with respect to the distributed property. This provision helps registered funds avoid adverse tax consequences to their remaining shareholders when a large shareholder redeems its shares in the fund, as it allows the fund to meet the redemption demand using a nontaxable in-kind distribution of securities rather than selling securities and recognizing gain that would later be distributed and taxed to the shareholders left behind.

[3] Investment Company Institute, 2021 INVESTMENT COMPANY FACT BOOK, Chapter 4.

[4] *Compare* Wyden Discussion Draft, *supra* note 1, at note 36 (citing a law review, which claims that section 852(b)(6) “unfairly benefits high-net-worth owners of ETFs”).

[5] Michael Wursthorn, *ETF Assets Swell to $9 Trillion*, WALL ST. J., Aug. 13, 2021, at B1, B10

KEY CONTACTS



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