EXCHANGE-TRADED FUNDS

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Proposal threatens ETFs' tax advantage

Sen. Wyden's draft legislation would change how in-kind transactions are considered

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Sarah Silbiger/Bloomberg

Sen. Ron Wyden wants to close loopholes he says the wealthy and corporations use.

A proposal from a powerful Senate Democrat to change the tax treatment for in-kind redemptions used by exchange-traded funds and mutual funds has asset managers concerned.

Sen. Ron Wyden, D-Ore., chairman of the Senate Finance Committee, released draft legislation on Sept. 10 aimed at closing "loopholes" he says are used by wealthy investors and corporations. The proposal includes a provision to repeal a section of the tax code that allows regulated investment companies — which ETFs and mutual funds are considered — to avoid recognizing gains when distributing appreciated assets to their shareholders.

"Because fund managers decide which securities to distribute, they distribute assets with unrealized gains and thereby significantly reduce the future tax burdens of their current and future shareholders," a 2017 paper from Fordham University Law Professor Jeffrey Colon said. Mr. Wyden cited the paper in a summary of his draft legislation. "Many ETFs have morphed into investment vehicles that offer better after-tax returns than IRAs funded with after-tax contributions," Mr. Colon said in the paper.

When an ETF seeks to offload appreciated securities for rebalancing or redemption purposes, it can avoid paying capital gains taxes on the securities by asking an accommodating party, such as a broker or bank, to buy shares in the fund and then exchange those shares for the appreciated securities. The tax rule used in this instance was written more than 20 years before ETFs came into existence.

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Mr. Wyden's proposal would have a greater impact on ETFs than mutual funds because the latter mostly make asset distributions to shareholders in cash. It would not impact ETFs in individual retirement accounts, just those in taxable brokerages, a spokeswoman for Mr. Wyden confirmed in an email.

The proposal would not have a big impact on institutional investors, many of which are tax-exempt, said Christopher C. Scarpa, a Philadelphia-based partner at law firm Stradley Ronon Stevens & Young LLP. "Institutional investors aren't buying the ETF for tax efficiency, they're buying the ETF for other reasons, which might be as simple as 'This is a mechanism that I can buy and sell in real time,'" he said.

The Senate proposal hasn't been formally introduced, but Mr. Wyden may try to include it as a way to pay for the Democratic social spending plan — aimed at addressing climate change, expanding Medicare, paid family and medical leave and child-care options, establishing universal prekindergarten, and other items — currently under negotiation.

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Opposition to proposal

ETF assets under management at the nearly 500 money managers tracked by *Pensions & Investments* grew 22.5% to $6.6 trillion for the year ended Dec. 31, an annual survey of the largest managers found. For the five-year period ended Dec. 31, ETF AUM was up 168.3%. Over those five years, the seven largest ETF managers — all with more than $100 billion in assets — grew in a range of 112% (State Street Global Advisors) to 400% (Charles Schwab Investment Management).

Some of those larger managers are worried about the impact of Mr. Wyden's proposal on the ETF market.

"We are opposed to this proposal and have concerns about the negative impact it could have on investors who consider ETFs an important investment option to help meet their future goals," State Street said in a statement.

A Vanguard Group Inc. spokesman said in an email that the "ability of mutual funds and ETFs to transact securities in-kind is a long-standing practice that improves outcomes for millions of investors," but added that the manager will refrain from commenting further until additional information about the proposal is released. Vanguard's ETF assets grew 31.5% year-over-year to $1.51 trillion as of Dec. 31.

BlackRock Inc., the largest ETF manager, saw its ETF assets rise 19.2% year-over-year to $2.67 trillion as of Dec. 31. In a statement, the company said: "We would be concerned about policies that would raise costs and reduce returns for long-term investors and retirement savers, and are carefully reviewing Sen. Wyden's proposal to better understand how it will impact millions of long-term investors."

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Varying viewpoints

Steven Rosenthal, a senior fellow at the Urban-Brookings Tax Policy Center in Washington, said reform in ETF taxation would be sensible. "As a general proposition, funds are given a lot of tax advantages because they pass their gains and income onto all their shareholders and they ought not to sidestep that obligation by distributing appreciated property to select shareholders," he said.

But Stradley Ronon's Mr. Scarpa believes the proposal would negatively impact the market. "You're disturbing the whole universe here saying that somehow the in-kind redemptions are now problematic," he said. "It disturbs the way funds work. And it wasn't a secret to members of Congress for the last 30 years."

Mr. Scarpa added: "If you're rallying cry is that 'we're going to shut down this loophole that wealthy investors are taking advantage of,' well, that's not really the case."

That was a point made by Eric J. Pan, president and CEO of the Washington-based Investment Company Institute, during a speech at the group's tax and accounting conference on Sept. 21.

"The ICI is against this proposed change to the tax treatment for in-kind redemptions because it could adversely impact over 100 million Americans that invest in ETFs and mutual funds to save for retirement, pay for higher education, afford a down payment for a house, and reach other milestones that help American families build financial security," Mr. Pan said.

Nearly 12 million U.S. households own ETFs and the median income of these households is $125,000, according to ICI data.

Mr. Pan said changing the tax treatment for in-kind redemptions will "penalize the exact same American investors that the Biden administration has identified as the individuals that most need to build financial security."

The proposal would also make long-term investing less attractive to younger Americans, Mr. Pan said. "The increased taxes and costs that will result from this proposal will make it harder for ETFs to be viewed by young Americans as a desirable investment choice, and it could very well discourage long-term investing by younger Americans," he added.

Democrats are aiming to pass the social spending bill via reconciliation process, meaning they will need only a simple majority to pass it in the Senate instead of the usual 60 votes. Republicans have widely criticized the package, and none are expected to support it in either chamber. Democrats control each chamber by slim margins and are still negotiating what a final package will look like.

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