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Congress Must Spike "FIFO" for All Investors

By Paul Schott Stevens

As the House and Senate reconcile their differing versions of tax reform, one provision from the Senate's bill should be deleted immediately. Tax reform must not impose an accounting system known as "first-in, first-out" (FIFO) that would deprive America's investors of their long-standing ability to manage their finances for the greatest tax efficiency.

Under current law that has stood for decades, investors selling securities can choose which specific shares they sell. Typically, investors purchase a particular stock or mutual fund in several transactions over many years, each purchase constituting a separate "tax lot." When investors sell, they can choose to manage their tax liability by selling the lot that bears the smallest capital gains tax.

Given that stock and fund prices tend to rise over time, investors often hang on to the shares they've held the longest. By managing their tax lots of shares, investors can improve their after-tax returns and get more value from the money they've put to work. The Senate bill would change that by generally requiring investors to always sell the oldest tax lots on an account-by-account basis—shares purchased "first in" must be sold "first out."

Requiring FIFO Will Harm Investors, Reduce Benefits of Tax Reform

The FIFO requirement is a fundamental change that takes away choice and reduces investors' ability to manage their financial lives. It strikes particularly hard at investors of relatively modest means, who have less ability to work around FIFO by maintaining multiple accounts. And it could harm the efficient use of capital in the economy, as tax-wary investors hold positions that they'd prefer to sell, rather than freeing up their money to seek new opportunities.

The original version of the Senate bill would have hit mutual fund investors particularly hard, forcing funds to pass along significantly higher capital gains distributions to their shareholders. The bill was amended during committee debate to exempt regulated investment companies—including mutual funds and exchange-traded funds—from the FIFO requirement on trades within their portfolios.

As the leading association for regulated funds, ICI is grateful for that amendment. But let's be clear: the exemption from FIFO isn't a special break for the portfolio managers or "professional investors" who manage funds on behalf of shareholders. The benefits of maintaining current tax treatment flow directly to fund shareholders, who are the ultimate owners of fund assets. More than 100 million Americans use funds to save for retirement, education, housing, and other vital financial goals. Fund shareholders—not fund managers—are the ones who will enjoy better after-tax returns and more money for their old age, their children's college bills, or the home they want to buy.

Let's be clear on something else: the same benefit should be available for investments of all types. Despite the exemption for fund portfolios, the rule imposing FIFO on other instruments will hurt investors and reduce any economic benefit that tax reform might bring. And it won't even simplify the tax code—though investors and their advisers already have the experience and systems they need to manage tax lots, FIFO's incentive to create multiple accounts could make investing and tax preparation even more complex and expensive.

The way forward is clear: House and Senate conferees should drop the FIFO requirement immediately, for all investors.

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Paul Schott Stevens was President and CEO of ICI.

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