

IRS AND TREASURY DISCUSS CURRENT ISSUES WITH ETFS AND TAX AWARE STRATEGIES

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US Asset Management and Investment Funds Alert

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On the morning of 21 July 2026 at a meeting of the Wall Street Tax Association, officials from the Internal Revenue Service (IRS) and Department of Treasury (Treasury) joined in a discussion with income tax professionals about various transactions, including transactions involving exchange-traded funds (ETFs), in which the government has taken an interest because the tax treatment of the transactions seems “too good to be true.” The officials declined to “bless” any particular transactions as being outside of the scope of the government’s inquiries, but the officials did describe in some detail the transactions in which they have taken an interest.

For ETFs, the transactions discussed at the meeting involve an ETF’s use of section 852(b)(6) of the Internal Revenue Code of 1986, as amended (the Code), to distribute assets in-kind without recognition of gain. The officials indicated that they were not troubled by the availability of section 852(b)(6) to ETFs in general, but the application of the section in some contexts had caught their eye. The discussions relating to ETFs included the following:

- In-kind contributions of assets by shareholders in seeding new ETFs intended to be nontaxable under section 351 when the contributed assets are later distributed to redeem ETF shares in transactions intended to be nontaxable under section 852(b)(6).
- Tiered ETF structures, where an ETF invested in shares of other ETFs and used section 852(b)(6) to distribute the portfolio ETF shares in-kind to avoid receiving income and gain distributions from those ETFs.
- ETFs investing in assets, such as cryptocurrencies, that do not generate qualifying income for regulated investment company purposes, and using section 852(b)(6) to distribute such assets and avoid recognizing the nonqualifying income.
- ETFs using section 852(b)(6) to avoid recognizing gain on options strategies, such as box spreads, by distributing the options in-kind.

Other transactions (not necessarily involving ETFs) discussed in the meeting included the following:

- The application of the swap (notional principal contract) regulations and engaging in swap transactions, including swap terminations, that result in a pattern of capital gains and ordinary losses.
- Making elections under section 988 selectively (and late in the day) to produce a combination of capital gains and ordinary losses.
- The use of the identified straddle election to achieve ordinary losses rather than capital losses.

BACKGROUND ON SECTION 852(B)(6) ISSUES

In 1986, Congress enacted a new corporate tax provision—Code section 311(b)—causing corporations to recognize gain when they distribute appreciated property to their shareholders. At the same time, Congress provided an exception for open-end regulated investment companies (each, a RIC) when they make an in-kind distribution of appreciated securities if the distribution is in redemption of the RIC's stock upon the demand of the shareholder. This exception is section 852(b)(6). Most think this exception was provided as relief to mutual funds faced with large shareholder redemption requests. Being able to distribute securities in-kind to the redeeming shareholder without recognizing gain protects the nonredeeming shareholders from capital gain distributions they would otherwise receive if the RIC had to sell appreciated securities to redeem the departing shareholder using cash.

The relief provision—section 852(b)(6)—came to play an important role in the function of RIC ETFs, which first appeared in the United States seven years after the Code provision was enacted. The issuance and redemption of creation units play an acknowledged nontax role in allowing the exchange trading of ETF shares to function and in keeping the market value of ETF shares close to the net asset value of those shares. That function would not work as well if the creation unit redemptions were taxable to the ETFs.

The issuance and redemption of ETF creation units—and the nonrecognition tax treatment of in-kind redemptions—have played an evolving and growing role as ETFs themselves have evolved from index funds to actively managed funds to funds employing ever more sophisticated investment strategies, and as the total value of assets held and managed by ETFs has grown ever larger.

In addition to organic market growth of ETFs as an attractive investment, some part of the growth of ETFs has come from conversions of mutual funds, using the Code's nontaxable corporate reorganization provisions, thereby making section 852(b)(6) more usefully accessible to the converted funds. Also, mutual funds themselves have started making more use of section 852(b)(6) through liquidity facilities and other arrangements provided by investment banks. Further use of section 852(b)(6) by mutual funds may be on the way, as mutual funds start to add ETF share classes.

Additional ETF growth has originated from in-kind contributions by individuals to newly formed ETFs. The corporate reorganization provisions are not available to individuals, so they have sought to use the nonrecognition provisions of section 351, available to people who contribute property in-kind in the formation of a new corporation.

All these developments have attracted attention along the way from journalists, academics, and members of congressional tax-writing committees. Critics have recently focused on the coupling of nonrecognition provisions, such as the use of section 351 by individuals to contribute their appreciated securities portfolios to an ETF in a nontaxable transaction followed by the ETF's distribution of those securities in a nontaxable section 852(b)(6) redemption of creation units. The additional uses of section 852(b)(6) as a tax-planning tool in connection with specific investment strategies has also drawn notice. These criticisms were reflected in many of the transactions addressed by the IRS and Treasury officials at the 21 July meeting.

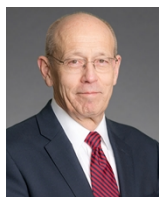
NEXT STEPS

As part of the 21 July 2026 discussion, government officials solicited input from the investment management community, including more detailed information about transactions from transaction participants. The officials made it clear that the government is planning to take steps to draw lines between what it sees as transactions within the intended scope of the tax provisions being discussed and those transactions it views as producing tax results that are “too good to be true.” Industry input could assist the government in drawing such lines.

The officials also made it clear that they are considering the possible use of all of the various types of regulatory tools at their disposal for addressing these issues.

Finally, although the participating government officials repeatedly declined to “bless” any particular transactions or strategies, they acknowledged the continuing importance of: (a) section 852(b)(6) to the operation of ETFs in the ordinary course; (b) the viability of section 351 contributions to ETFs in which the contributed assets fit the investment profile of the ETF and dispositions of assets are made in the ordinary course of business; and (c) an absence of concern about many traditional tax-planning strategies.

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