

CLIENT ALERT

IRS Guidance Limits Section 351/ETF Conversions and Puts Private Funds Pursuing Certain Tax-Aware Strategies on Notice

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On September 28, 2026, the Treasury Department and the IRS issued Revenue Ruling 2026-20 (the “Ruling”)¹ and Notice 2026-62 (the “Notice”),² addressing Section 351/exchange-traded fund (“ETF”) conversions, the use by ETFs of in-kind redemptions to avoid current income or non-qualifying income, and the use by investment funds of certain technical derivatives rules to generate capital gains and ordinary losses in tax-aware strategies.

The Ruling applies substance-over-form and step-transaction principles to hold that certain transfers of appreciated securities to an ETF as part of a plan involving in-kind redemptions (as discussed below) are properly characterized as taxable exchanges under Section 1001,³ rather than nonrecognition transactions under Section 351.

¹ Revenue Ruling 2026-20 is available [here](#).

² Notice 2026-62 is available [here](#).

³ All Section references herein refer to Sections of the U.S. Internal Revenue Code of 1986, as amended (the “Code”).

The Notice identifies several strategies, including the Section 351/ETF conversion addressed in the Ruling, that the IRS views as potentially abusive and warns that the Treasury Department and the IRS are considering issuing future guidance, including potential designations as “listed transactions” or “transactions of interest,” to address the tax strategies described in the Notice (which guidance may apply prospectively or retroactively). The Notice further indicates that the IRS may also challenge an abusive investment fund strategy upon examination as inconsistent with existing law.

The concerns addressed in the Ruling and Notice largely mirror the issues addressed by Kevin Salinger and Erika Nijenhuis of the Treasury Department on a July 21, 2026 panel hosted by the Wall Street Tax Association. According to Salinger and Nijenhuis, these transactions all involve combining or sequencing technical rules to produce results that Congress did not intend.

Section 351/ETF Conversions under Revenue Ruling 2026-20

In the Ruling, the conversion begins with an investor transferring a diversified portfolio of appreciated securities to a newly formed ETF in a purported non-taxable Section 351 exchange. As part of the same plan, the ETF issues shares to an “authorized participant” (“AP”) in exchange for securities consistent with the ETF’s investment thesis, or for cash that the ETF intends to use to acquire those securities. Shortly thereafter, in a transaction intended to qualify for nonrecognition under Section 852(b)(6), the ETF redeems the AP’s shares in exchange for securities originally contributed by the investor.

At the end of the planned transactions, the ETF holds a portfolio of securities that is both “materially different” from the portfolio contributed by the investor and consistent with the ETF’s investment thesis, whereas the investor holds shares in an ETF with the materially different portfolio.

Treating the contribution as a nonrecognition transaction under Section 351, by itself, is not remarkable because the built-in gain in the contributed securities is preserved in the hands of the ETF and in the ETF shares received by each transferor. The Section 351 transfer, however, can raise policy concerns when the ETF eliminates entity-level built-in gain by distributing the assets through an in-kind redemption.

Applying the substance over form and step-transaction doctrines, the Ruling holds that the transfer of securities by the investor to the ETF is properly recharacterized as a taxable exchange with the AP under Section 1001. The Ruling explains that the plan was designed to achieve the economic equivalent of an exchange of the appreciated securities for a materially different portfolio that aligns with the ETF’s investment thesis, without recognition of the built-in gain in the contributed securities, and reasons that the ETF was merely a conduit for the transfer of securities from the investor to the AP. Thus, the transfer of the appreciated securities to the ETF is not respected as a nonrecognition transaction under Section 351 and the investor is treated as having disposed of its securities for other property differing materially in kind or extent in a taxable exchange with the AP. The Ruling further notes that the result would be the same if multiple investors had engaged in the transaction.

The Ruling does not clearly state what assets the investor is treated as receiving in the taxable exchange with the AP. Specifically, it does not state whether the investor is treated as having received, in the deemed exchange between the investor and the AP, the portfolio or cash that the AP contributed to the ETF (which the investor would then be deemed to have contributed to the ETF) or the ETF shares that were issued by the ETF to the AP.

The key questions in applying the Ruling are whether a contribution of appreciated property and a later in-kind redemption are pursuant to a common plan and whether the two portfolios of securities are “materially different.” No specific guidance is provided on these questions. The determination of what is “materially different” may be informed by the Notice’s description of a Section 351 conversion transaction as involving a transferred portfolio of appreciated securities where some or all of the securities in the transferred portfolio do not align with the ETF’s contemplated portfolio or investment thesis, or the transferred portfolio may have an overconcentration of one or more securities as compared to the ETF’s contemplated portfolio.

Notice 2026-62

The Notice identifies, and requests comment on, various “investment fund strategies that purport to produce tax results that may be inconsistent with the purposes and proper application of the relevant federal tax rules” and indicates that the Treasury and the IRS are considering issuing additional guidance or taking other action to address the transactions identified in the Notice. Such guidance, if issued, could include regulations, notices and revenue rulings and, as noted earlier, could involve the designation of one or more transactions as “listed transactions” or “transactions of interest” and could apply prospectively or retroactively.

Specifically, the Notice addresses (i) strategies involving “atypical” usage of Section 852(b)(6) redemptions by ETFs, and (ii) certain strategies used by “tax-aware” funds.

Strategies Involving Atypical Usage of Section 852(b)(6) Redemptions

The Notice identifies and discusses various transactions (discussed below) that each involve an ETF’s use of in-kind redemptions under Section 852(b)(6). ETFs are treated as regulated investment companies (“RICs”) and Section 852(b)(6) permits a RIC to distribute appreciated securities without recognizing the gain inherent in those securities, if the distribution is in redemption of RIC stock upon the demand of a shareholder. The redeemed shareholder’s basis in the securities received in the redemption equals their fair market value and the gain it recognizes in the transaction may be limited or non-existent if the value of the assets it receives approximates or equals its purchase price for its ETF shares.

The Notice espouses the view that the Section 852(b)(6) redemption transactions identified in the Notice are used to produce results that are inconsistent with the purpose and proper application of that provision and, in several cases, are used to avoid the inclusion by an ETF or its shareholder of income or gain contemplated by the Code (as opposed to being used to operate the ETF in the normal course of carrying out its investment strategy).

Transfers to Controlled Corporations in Transactions Intended to Qualify under Section 351. The Notice discusses the Section 351/ETF conversion transactions that are the subject of the Ruling described above and indicates that, in addition to issuing the Ruling, the Treasury Department and the IRS are considering further guidance to address Section 351 conversion transactions. The Notice expressly does not address (or provide any view on) Section 351 transactions used to seed a newly established ETF with assets that are consistent with the ETF's investment thesis and that are intended and expected to be retained by the ETF absent a substantial change in circumstances.

Transfers to Partnerships in Connection with a Section 351 Conversion Transaction. The Notice identifies a "partnership variation" of a Section 351 conversion transaction in which investors contribute non-diversified portfolios of appreciated securities to a partnership that invests at least 20 percent of its assets in property other than stocks and securities. As part of the same plan, the partnership (which assembles a diversified portfolio from the concentrated positions contributed by its partners) then engages in the Section 351/ETF conversion transaction described above. The investors in the partnership take the position that the transfers to the partnership qualify for nonrecognition under Section 721(a) (and avoid the exception thereto in relation to transfers to an "investment company" because more than 80 percent of the partnership's assets are not invested in stocks or securities such that the partnership is not an investment company), and further take the position that the partnership's contribution of its diversified portfolio to the ETF qualifies for nonrecognition under Section 351. The partnership variation of the Section 351 conversion transaction purportedly allows the investors to avoid recognition of built-in gains in their securities while effectively exchanging them for an indirect interest in an ETF with a materially different (and diversified) portfolio of securities.

While the Ruling denies the application of Section 351 nonrecognition in the context of the partnership's contribution to the ETF, the Notice indicates that the Treasury Department and the IRS are considering other guidance that would deny nonrecognition treatment to the contributions to the partnership discussed above or otherwise recharacterize those contributions in a manner that reflects the proper substance of the transactions for federal income tax purposes.

Box Spread Funds. The Notice describes a transaction in which certain ETFs use a combination of four options on the same underlying property to generate a Treasury-type return similar to a short-term interest rate (a "box spread").

The ETF enters into the box spread with options that are not Section 1256 contracts, and before the options in the box spread expire, the ETF separates the appreciated components of the box spread using a distribution intended to qualify for nonrecognition under Section 852(b)(6). By issuing a creation unit to an AP in exchange for cash or property and then distributing the appreciated options in redemption of the creation unit, the ETF purportedly would avoid recognizing income or gain, and investors purportedly would not recognize current income (despite benefiting from a return similar to the short-term interest rate). If the investors in the ETF were to subsequently sell or dispose of their ETF shares, they would recognize capital gain reflecting the increase in value of the shares from the ETF's use of the box spread.

The Notice also describes a similar transaction in which an ETF uses both a box spread and offsetting positions that constitute a “straddle.” The ETF distributes the positions in the straddle that have unrealized gain, and takes the position that it can deduct the loss on the remaining straddle positions, notwithstanding that the gain in the offsetting positions is never recognized, and utilize the loss to offset income from the box spread or other income of the ETF.

Record Date Strategies. The Notice identifies transactions in which some equity ETFs (parent ETFs) invest in other equity ETFs (acquired ETFs) to purportedly avoid recognition of dividend income by making a redemption distribution of stock of the acquired ETF prior to the dividend record date.

The Notice specifically addresses situations in which a parent ETF seeking a return that tracks an index may invest in acquired ETFs tracking that same index. Shortly before an acquired ETF’s dividend record date (but generally after the dividend declaration, so that the price of the acquired ETF shares has increased to reflect the anticipated dividend), the parent ETF issues a creation unit to an AP in exchange for cash or shares of a different ETF tracking the same index. The parent ETF then distributes the acquired ETF’s shares to the AP in an in-kind redemption of the parent ETF shares.

The parent ETF generally maintains its exposure to the same index throughout the transaction and purportedly avoids taxable dividend income in respect of the distributed acquired ETF shares, without any material change to the economic characteristics of the parent ETF’s assets. The shareholders purportedly recognize no income or capital gain until they dispose of their parent ETF shares.

The Notice expressly does not address (or provide any view on) transactions involving ETFs that invest in other ETFs that track different indices.

RIC Income Test Avoidance. The Notice identifies transactions in which certain ETFs take the position that they can circumvent the Section 851(b)(2) RIC income test by avoiding the recognition of gains with respect to a distributed asset that would not be qualifying income under Section 851(b)(2).

Specifically, an ETF invests directly in assets that would produce non-qualifying income under the RIC income tests if sold or exchanged by the ETF, such as positions in commodities or digital assets, which might be held directly or through grantor trusts.

Rather than selling these assets, the ETF distributes them in redemption of creation units in transactions intended to qualify under Section 852(b)(6), taking the position that gain realized but not recognized is not taken into account for purposes of applying the RIC income test.

This strategy purportedly allows the ETF to limit its gross income that is subject to the RIC income test without regard to the ETF’s economic income.

The Notice expressly does not address (or provide any view on) other forms of investments in assets that would give rise to non-qualifying income for a RIC, such as investments in such assets through “controlled foreign corporations.”

Strategies Used by Tax-Aware Funds

The Notice identifies and discusses various strategies (discussed below) of particular interest to the Treasury Department and the IRS that are employed by some “tax-aware” investment partnerships or separately managed accounts, including strategies that, per the Notice, seek to create a pattern of generating capital gain and ordinary loss in similar amounts from economically offsetting transactions or seek to achieve effective character electivity by using certain tax elections in ways that are inconsistent with their purpose.

Section 1092(a)(2) Identified Straddles with Mixed Character. The Notice describes transactions in which tax-aware funds are using identified straddles that use offsetting positions to generate gross capital gain and ordinary loss in a manner that the Notice states is inconsistent with congressional intent.

It cites, as an example, a strategy in which an investment fund enters into a foreign currency straddle consisting of a forward contract giving rise to ordinary income/loss and a futures contract giving rise to 60 percent long-term capital gain/loss and 40 percent short-term capital gain/loss under Section 1256(a)(3). The fund identifies the contracts as an identified straddle under Section 1092(a)(2).

Regardless of the performance of the contracts, the fund terminates the futures contract first. If the futures contract is profitable, the fund recognizes capital gain followed by a corresponding ordinary loss on the forward; if the futures contract is at a loss, the fund capitalizes that loss into the basis of the ordinary forward contract position under Section 1092(a)(2)(A), reducing ordinary income or producing an ordinary loss on the forward contract.

The Treasury Department and the IRS further note their awareness of a similar strategy involving identified straddles consisting of a notional principal contract that is an equity index swap and a futures contract on the same index.

Same-Day Acquisitions and Dispositions of Foreign Currency Forward Contracts. The Notice identifies a strategy in which an investment fund enters into foreign currency forward contracts that expire or are terminated on the same day they are entered into, which by default produce ordinary income or loss under Section 988(a)(1)(A).

After completing its trading for the day, the fund elects the application of Section 988(a)(1)(B) for contracts that closed at a gain (converting that gain to capital gain) but makes no such election for contracts that closed at a loss (retaining their ordinary character). Since the contract terminates or expires on the same day it is entered into and the election to apply Section 988(a)(1)(B) capital gain/loss treatment is required to be made by the close of that same day, the fund has full knowledge at the time it makes the Section 988(a)(1)(B) election as to whether the election in respect of a particular position will be advantageous (and can thus selectively determine only to make the election in cases that benefit the fund).

The Treasury Department and the IRS view this hindsight-based selectivity as contrary to the intent of Section 988(a)(1)(B).

Selective NPC Terminations Used to Obtain Inconsistent Character. Swaps are generally treated as notional principal contracts (“NPCs”) for tax purposes. Under current NPC rules, a periodic and non-periodic payment is ordinary, but a termination payment is capital in character. A non-periodic payment includes a final scheduled payment. Periodic and non-periodic payments are generally accrued on a daily basis. Regulations proposed in 2004 would have required accruals of certain contingent payments, but these regulations were never finalized. In contrast, termination payments are taken into account in the year of the termination.

In the transactions considered in the Notice, an investment fund that is a trader (but which does not elect mark-to-market treatment under Section 475(f)) enters into short-term NPCs that provide for contingent payments generally tied to the value of an underlying stock. The investment fund does not accrue any amount with respect to the contingent payments, but rather takes these amounts into account when paid. If the NPC is at a loss, the taxpayer holds through maturity and claims an ordinary loss for the final non-periodic payment; if the NPC is at a gain, the taxpayer terminates the NPC shortly before the date of the final scheduled non-periodic payment and takes the position that the termination payment (which is from the same party that would have made the final scheduled non-periodic payment) gives rise to capital gain under Section 1234A. The fund purports to generate gross capital gain and gross ordinary losses, which provides valuable federal income tax benefits to investors, in reliance on the distinction between the ordinary treatment of scheduled payments and the capital treatment of termination payments (and, per the Notice, benefits from “using selectivity to achieve different character for similar payments on identical financial instruments, contrary to the purposes of the timing and character rules” relating to NPC payments).

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The Treasury Department and the IRS indicated that it is their intent that any future guidance to address the transactions described in the Notice will target specific abusive transactions and respect market expectations with respect to conventional, long-established tax planning that is consistent with the intent of Congress. ETFs, investment funds and their respective investors will need to closely monitor developments in this area and consider whether any future guidance may impact any of their contemplated or consummated transactions.

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