

# Treasury Targets ETF and “Tax-Aware” Fund Strategies

October 5, 2026

The Treasury Department released Notice 2026-62 (the “Notice”) and Revenue Ruling 2026-20 (the “Revenue Ruling”), which target various investment fund strategies utilized by exchange-traded funds (“ETFs”) and other so-called “tax-aware” funds that the government describes as purporting to “produce tax results that may be inconsistent with the purpose and proper application of the relevant federal tax rules.”

## Key Takeaways:

- In the Revenue Ruling, the IRS ruled that a “Section 351 conversion transaction” strategy used by some ETFs to enable investors to engage in tailored diversification of their investments is ineligible for nonrecognition treatment.
- The Notice identifies several other ETF and “tax-aware” fund strategies that may produce tax results inconsistent with the purpose of the tax rules, including strategies that achieve deferral or character conversion.
- The guidance highlights transactions Treasury believes are potentially abusive, not “conventional, long-established tax planning that is consistent with the intent of Congress.”
- The Revenue Ruling contains no effective date or transition relief, so the IRS may apply it to transactions already completed. Future guidance could apply retroactively, and the IRS may challenge these strategies under existing law now.

The Revenue Ruling takes immediate action on one strategy utilized by ETFs, identified as the “Section 351 conversion transaction” (described below) while the Notice merely identifies certain strategies of potential concern and requests comments. Several of the strategies involve targeted use of Section 852(b)(6) of the Code, which allows a regulated investment company (a “RIC”) to distribute appreciated securities to a shareholder redeeming its shares without recognizing gain. Others are used by tax-aware funds to create opportunities for deferral or elective character conversion.

Comments on the transactions highlighted in the Notice are requested by October 28, 2026.

### **Background on Section 852(b)(6) and Transfers of Assets to RICs**

ETFs typically elect to be taxed as RICs due to favorable tax rules that treat a RIC much like a pass-through entity, in that a RIC generally does not pay tax at the entity level. RICs are also eligible for a special nonrecognition rule under Section 852(b)(6), which allows them to distribute appreciated property to their shareholders in an on-demand stock redemption without recognizing gain under Section 311(b), unlike distributions by non-RIC corporations. RICs are unique in being able to distribute property to a redeeming shareholder without recognizing gain or reducing the basis of retained property.

Section 351 generally allows for tax deferral when appreciated assets are transferred to a corporation in exchange for stock if certain requirements are met. However, for a transfer to a RIC or other investment company, tax deferral is available only if the transfer does not result (directly or indirectly) in the “diversification” of the investments transferred by the transferor.<sup>1</sup> For this purpose, “diversification” does not result if each transferor contributes investments that already qualify as “diversified” prior to the transfer.<sup>2</sup> An anti-abuse rule applies if a transfer is part of a plan to achieve diversification without recognizing gain.

Although mutual funds and other entities are also typically taxed as RICs, the Notice specifically focuses on ETFs because publicly traded ETFs engage in primary transactions with financial institutions called “authorized participants.” An authorized participant (“AP”) is permitted to acquire shares directly from an ETF. The ETF can then redeem the authorized participant’s shares through in-kind distributions of appreciated securities (as opposed to cash from having sold assets) that benefit from the nonrecognition rule in Section 852(b)(6) described above.

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<sup>1</sup> Investment company status is based on an asset test, the operation of which can be difficult to measure in practice.

<sup>2</sup> A portfolio is considered to be a “diversified portfolio” where, among other requirements, no single issuer constitutes more than 25% of the portfolio and the five largest holdings amount to no more than 50% of the total. This is sometimes referred to as the “25/50 test.”

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## Section 351 Conversion Transaction

### The Revenue Ruling

The Revenue Ruling considers whether a transfer of securities to a newly formed ETF qualifies for nonrecognition treatment under Section 351 if, as part of the same plan, some or all of the transferred securities are distributed pursuant to Section 852(b)(6) in redemption of shares held by an AP. The facts describe an investor who transfers an appreciated “diversified portfolio” to a newly formed ETF that is taxed as a RIC. Pursuant to that same plan, the ETF issues shares to an AP in exchange for securities that are consistent with the ETF’s investment thesis. Shortly thereafter, the ETF redeems the AP’s shares in exchange for the securities that the investor previously transferred to the ETF. The result of this plan is that the ETF holds a portfolio of securities that is “materially different from the portfolio transferred by the investor.”

**Debevoise Comment:** The transactions are intended to permit the investor to diversify further into an indexed return without recognizing gain on its appreciated holdings, without maintaining any exposure to the investor’s original investment portfolio.

Applying the substance-over-form and step-transaction doctrines, the Revenue Ruling disregards the ETF’s transitory ownership of the contributed securities and concludes that the investor is treated as having sold its contributed securities directly to the AP.

**Debevoise Comment:** The Revenue Ruling’s analysis centers on a plan with three key elements: the investor’s intent to diversify its holdings without recognizing gain; the seeding of a new ETF with securities that the ETF never intends to retain; and the AP’s acquisition of ETF shares solely to facilitate the Section 852(b)(6) redemption that occurs “shortly thereafter.” The Revenue Ruling does not clarify how different an ETF’s resulting portfolio must be from the portfolio the investor initially transferred in order to be “materially different,” or how much time must elapse between the steps of the transaction for the later step to not follow “shortly thereafter” the first.

### The Partnership Variation: Exchange Funds

The Notice describes a partnership variation where, as part of a plan, investors contribute on a tax-deferred basis a *non-diversified* portfolio to a partnership (referred to in the Notice as an “exchange fund”) that is organized not to meet the definition of an investment company.<sup>3</sup> The partnership itself owns a diversified portfolio, which is then contributed to an ETF in a Section 351 conversion transaction as part of the same plan to undertake a similar transaction as described above, with the result being that the

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<sup>3</sup> For transfers to qualify under Section 721, the exchange fund must hold at least 20% of its gross assets in certain non-liquid assets, often leveraged real estate.

investor diversifies its portfolio into an indexed return without recognizing gain, without retaining an interest in its original portfolio.

**Debevoise Comment:** Conversions of private funds to RICs typically are tax-deferred either because the fund transfers a diversified portfolio or, where each fund vehicle contributes the same assets, there is no diversification. The in-kind distribution differentiates this transaction from run-of-the-mill conversions.

The Treasury Department and the IRS state that they continue to consider other guidance that would deny nonrecognition for the contributions to the partnership or otherwise recharacterize them to reflect the substance of the underlying transactions.

**Debevoise Comment:** Although the Revenue Ruling does not address exchange funds, it would apply to an exchange fund that conducts a Section 351 conversion transaction. If so, any gain that results to the exchange fund would be allocated to its partners. The Treasury Department's and the IRS's stated interest in further guidance on the partnership contribution itself suggests that they are considering whether the partners' initial contributions could be recharacterized as well.

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## Other Section 852(b)(6) Strategies Highlighted in the Notice

### Box Spread Funds

The Notice addresses certain ETFs that seek to generate a stable, interest-like return through a "box spread," a combination of four options on the same underlying asset that, taken together, produce a return similar to a risk-free return on Treasury bills. The ETFs described in the Notice use options that are not subject to the year-end mark-to-market rules of Section 1256. Before the options with built-in gain expire, the ETFs distribute those appreciated positions to an AP in an in-kind redemption intended to qualify for nonrecognition under Section 852(b)(6). The interest-like return increases the value of the shares of the ETF held by the investor. While the investor eventually will pay tax on such appreciation upon a sale of the interests in the ETF, the box spread transaction allows an investor to enjoy current tax deferral and potentially long-term capital gain treatment on the return.

The Notice signals that the Treasury Department and the IRS are scrutinizing the use of Section 852(b)(6) to eliminate fund-level tax on gains embedded in these box spread strategies, and further guidance or other action may follow.

## Record Date Strategies

The Notice describes equity ETFs (each, a “parent ETF”) that invest in other equity ETFs (each, an “acquired ETF”) that track the same index, in a strategy designed around tax deferral for parent ETF shareholders that again may convert current dividend income into deferred capital gain.

Shortly before the record date for payment of a dividend by an acquired ETF, the parent ETF distributes the acquired ETF shares to an AP pursuant to an in-kind redemption intended to qualify for nonrecognition treatment under Section 852(b)(6), and then replaces those shares with different acquired ETF shares using cash contributed by the AP. On the basis of these offsetting transactions, the parent ETF takes the position that it does not recognize dividend income. Although there is no material change in the economics of the parent ETF’s assets, the parent ETF shareholders take the position that they may defer recognition of all income or gain until they dispose of the parent ETF shares.

**Debevoise Comment:** The focus of the Notice is on same-index substitution. A carve-out for ETFs that invest in other ETFs tracking different indices suggests that a genuine change in economic exposure is a critical factor.

## RIC Income Test Avoidance

The Notice identifies the use of Section 852(b)(6) by certain ETFs to avoid recognizing gains that would not constitute qualifying income for purposes of the RIC income test under Section 851(b)(2). To qualify as a RIC, at least 90% of a corporation’s gross income generally must consist of specified categories of qualifying income. According to the Notice, certain ETFs invest directly in assets—such as commodities or digital assets—that would generate nonqualifying income if sold or exchanged at a gain.

The ETFs distribute appreciated assets to an AP in transactions intended to qualify for nonrecognition under Section 852(b)(6) and take the position that the realized but unrecognized gain is not taken into account for purposes of the RIC income test, thereby permitting them to limit the amount of nonqualifying gross income counted toward the 90% test without regard to their economic income.

**Debevoise Comment:** The Notice narrowly focuses on the use of Section 852(b)(6) in-kind distributions and does not address other strategies by which RICs invest in assets that could produce nonqualifying income, such as investing through a controlled foreign corporation.

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## Other Strategies Highlighted by the Notice Used by “Tax-Aware” Funds

### Identified Straddles Used to Convert Character

The Notice describes a transaction where “tax-aware” funds enter into a straddle in a foreign currency using two different instruments: a futures contract and a forward contract.

Under the identified straddle rules, a taxpayer may identify offsetting positions as a straddle, and a loss on one position is then taken into account by increasing the tax basis of the offsetting position. An example of this strategy involves using two economically offsetting instruments, a futures contract and a forward contract in the same foreign currency. The fund first terminates the futures contract. If the futures contract is in a gain position the fund recognizes the gain at a favorable 60% long-term/40% short-term capital gain rate under Section 1256, while ordinary loss would be recognized on the forward contract. However, if the futures contract is in a loss position, that loss is added to the basis of the forward contract, reducing gain or giving rise to an ordinary loss. This creates a favorable capital gains ordinary loss mismatch if the futures contract appreciates, while neutralizing the opposite tax result if the futures contract declines in value.

The Notice states that it does not address straddles that give rise to consistent character and holding periods regardless of whether the straddle has a gain or loss.

**Debevoise Comment:** The focus of the Notice is on the use of the identified straddle rules and the asymmetric tax consequences that the identified straddle election can create. The carve-out for straddles that produce consistent tax consequences suggests that the differing tax character of the two legs, together with the asymmetric tax consequences, are the key points of focus for Treasury.

### Same-Day Acquisitions and Dispositions of Foreign Currency Forward Contracts

The Notice addresses an investment fund strategy involving same-day foreign currency forward contracts, which are agreements to buy or sell a specified amount of foreign currency at an agreed price that are both entered into and expire on the same day. Ordinarily, gain or loss on these contracts is treated as ordinary under the tax rules that govern transactions in foreign currency. However, a taxpayer is permitted to elect capital treatment if the transaction is identified by the close of the day on which it is entered into. The strategy described in the Notice takes advantage of that timing by waiting until the day’s trading is complete and then making the election only for

contracts that produced gains, causing those gains to be treated as capital while losses on otherwise identical contracts remain ordinary.

**Debevoise Comment:** The same day identification rule was intended to prevent the use of hindsight in electing capital treatment and does not contemplate that taxpayers could use hindsight for same-day trades to ensure gains are capital and losses are ordinary. The Notice signals that future guidance may restrict this selective use of the election while Treasury and the IRS consider how to address the strategy without disrupting established market practices.

### Selective NPC Terminations Used to Obtain Inconsistent Character

The Notice addresses a strategy involving notional principal contracts (“NPCs”), commonly referred to as swaps, under which payments may depend on the performance of an underlying stock or index. If an NPC has *appreciated*, the fund terminates the contract shortly before a scheduled payment and treats the amount received as a termination payment giving rise to capital gain under Section 1234A; however, if the NPC is in a loss position, the fund allows the scheduled payment or maturity to occur and treats the payment as a nonperiodic payment and ordinary loss that may offset unrelated ordinary income.

**Debevoise Comment:** Treasury and the IRS view this selective termination strategy as inconsistent with the purposes of the NPC timing and character rules, which generally contemplate ordinary treatment for periodic and nonperiodic swap payments and capital treatment for payments attributable to a disposition of the contract. The Notice signals that future guidance may seek to prevent funds from obtaining different tax character merely by choosing whether to terminate an NPC immediately before a scheduled payment or allow that payment to occur.

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## Implications for ETFs and Tax-Aware Funds

The Revenue Ruling represents the IRS’s interpretation of existing law and contains no effective date or transition relief. As a result, the IRS may apply it to transactions completed before its release.

**Debevoise Comment:** The Notice acknowledges that certain tax-aware strategies are consistent with Congressional intent. For instance, an individual seeking exposure to a certain equity index can, instead of purchasing a RIC devoted to that index, acquire the underlying securities directly and harvest unrealized losses within its portfolio by regularly selling loss securities while retaining those held at a gain. The mere fact that such sales may be tax motivated is not in and of itself a cause for concern.

The Notice states that the Treasury Department and the IRS are contemplating additional guidance on the transactions described and requests comments on whether the descriptions are accurate, whether there are similar transactions with different facts or economics that warrant different treatment, what future guidance commenters would suggest with respect to concerns not otherwise addressed by the Revenue Ruling, and whether there are other fund strategies producing unintended results.

The additional guidance may apply either prospectively or retroactively to completed transactions, and may take the form of regulations, notices, revenue rulings, or other guidance, including the potential identification of a transaction as a transaction of interest or a listed transaction.

The Notice also cautions that the IRS may challenge abusive investment fund strategies as inconsistent with existing law, including the Code, Regulations, and applicable judicial doctrines.

**Debevoise Comment:** The language included in the Notice on potential retroactivity, and the possibility that strategies may be challenged as inconsistent with existing law, is an important practical point. Investors and funds with open or contemplated positions in any of these areas should evaluate their current exposure.

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Please do not hesitate to contact us with any questions.



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