

Treasury and IRS address certain investment fund strategies involving ETFs and financial products

October 6, 2026

In brief

What happened?

Treasury and the IRS on September 28 issued [Notice 2026-62](#) (the Notice) and [Rev. Rul. 2026-20](#) (the Revenue Ruling) on certain investment fund strategies involving exchange traded funds (ETFs) and other financial products. These documents follow from a panel held by the Wall Street Tax Association on July 21, 2026, where Treasury officials addressed a similar set of concerns.

Why is it relevant?

In summary, the Notice

- highlights several strategies involving ETFs and 'tax-aware' funds that Treasury and the IRS state may produce federal income tax results inconsistent with the purpose and proper application of existing rules;
- signals potential further guidance or other action related to those investment fund strategies and notes that the IRS may challenge those strategies on examination under existing law; and
- requests comments and information regarding the transactions described in the Notice and similar transactions.

The Revenue Ruling, issued concurrently with this Notice, outlines Treasury's and the IRS's analysis regarding the federal income tax characterization of certain Section 351 transactions involving ETFs.

Actions to consider

Market participants should evaluate how the guidance may affect the activities covered by the Revenue Ruling and the Notice, including Section 351 ETF seeding and subsequent portfolio changes and the exchange fund variation of this trade, other ETF strategies involving Section 852(b)(6), and the 'tax-aware' financial product strategies. They should also consider whether to comment on the scope of any future guidance. Comments are due October 28, 2026.

In detail

Background

For federal income tax purposes, an ETF that qualifies as a regulated investment company (RIC) is a corporation subject to special rules that generally result in a single level of tax on the RIC's income and gains at the shareholder level. ETFs regularly conduct in-kind creation and redemption transactions with authorized participants (APs). APs acquire large blocks of ETF shares directly from the ETF, generally by contributing a basket of securities and/or cash, and may redeem those shares for assets selected by the ETF. Section 351 generally permits an investor or AP acting as an agent for the investor to contribute appreciated securities to an ETF without recognizing gain when the investor controls the ETF immediately after the transfer and certain diversification requirements are satisfied. Section 852(b)(6) generally allows RICs, including ETFs, to distribute appreciated securities via certain in-kind redemptions without recognizing gain, which otherwise could be required to be distributed to investors. The Notice acknowledges these conventional practices and, except as specifically discussed below, places them outside its scope.

The Notice focuses on other ETF transactions described as involving an 'atypical' usage of Section 852(b)(6) that the government believes is inconsistent with the purpose and proper application of the provision. The Notice also discusses certain strategies that Treasury and the IRS have identified as relying on technical tax rules to create a pattern of generating capital gain and ordinary loss that tend to be within 'tax-aware' funds. The Notice focuses on situations where the government believes that the fund is 'manipulating' the character of tax items through the use of elections, identifications, ordering of terminations or the application of specific technical rules. Further, the Notice acknowledges that, while some of these funds may be primarily tax-motivated, others carry out bona fide profitable investment activity while engaging in the identified strategies.

The Revenue Ruling examines a scenario where Sections 351 and 852(b)(6) are applied together as part of a plan to enable an investor to defer gain recognition on securities by contributing them to an ETF. The ETF thereafter uses those securities for in-kind redemptions of shares held by an AP, on the basis that the contributed securities do not align with the ETF's investment strategy. As a result, the investor, through its investment in the ETF, ends up holding a materially different portfolio of securities.

Strategies identified in the Notice and Revenue Ruling

Section 351 strategies

- Section 351 ETF conversion transactions.** The Notice states that the IRS is aware of investment advisors promoting so-called '351 conversion transactions' resulting in the ETF investors not recognizing built-in gains upon contribution. The scope of the Notice and Revenue Ruling outline circumstances when, as part of a plan, a Section 351 contribution of securities to launch a new ETF is coupled with a Section 852(b)(6) redemption of securities 'to achieve a result that neither provision was designed to produce.' Specific to the Section 351 contribution in-kind, some or all of the securities in the transferred portfolio do not align with the ETF's contemplated securities portfolio or investment thesis and/or, in the context of the Notice, have an over-concentration of one or more securities compared to the ETF's contemplated securities following the completion of the planned transactions. The contribution results in a 'materially different' portfolio than the contemplated portfolio of the ETF. Pursuant to a plan, the contribution is followed by a Section 852(b)(6) redemption in-kind of the AP with the non-aligned securities 'shortly after the contribution.'

Applying substance-over-form and step-transaction principles, the Revenue Ruling concludes that the ETF was merely a conduit through which the investor's securities were transferred to the AP. Using the ETF, the investor was able to exchange its appreciated portfolio of securities for a materially different portfolio that aligns with the ETF's investment thesis without recognizing any built-in gains in those securities. Accordingly, the Revenue Ruling treats the investor as engaging in a taxable exchange of the contributed securities with the AP, resulting in recognition of gain under Section 1001.

- Partnership variation.** The Notice expands on the transaction above to discuss a variant using a partnership for investors whose appreciated portfolio of securities would not have qualified as a diversified portfolio for purposes of avoiding the application of Section 351's investment company restriction. In the partnership variation, investors contribute appreciated securities portfolios that are not diversified for purposes of Section 351(e) to a partnership that holds at least 20% of its assets in property that is not stock or securities, with the intention that the partnership would not be treated as an investment company if it were incorporated. The partnership subsequently engages in a Section 351 ETF conversion transaction described above.

Observations: The commentary in the Notice and the fact pattern in the Revenue Ruling state that, following the completion of the 'planned' transactions, the ETF holds a portfolio of securities that is 'materially different' from the portfolio contributed by the investor, but neither piece of guidance provides further definition on what is deemed 'materially different' in this context, leaving some lingering ambiguity. Similarly, 'shortly after the contribution' is not defined but it is inferred that the disposition of securities via the redemption in-kind ought to be in conformity with how ETF trades securities in the normal course of carrying out its investment strategy. The ruling appears to imply the investors can avoid the pitfalls of this guidance by contributing securities the ETF intends to hold or trade in the ordinary course of business.

While the Revenue Ruling describes the investor as recognizing gain, it does not explain how the entire transaction might be seen differently for tax purposes. How the transaction is viewed could affect the investor's basis in the ETF and the ETF's basis in the investor's transferred securities. Finally, as revenue rulings express the IRS's view of the application of current law to a set of facts, the Revenue Ruling is not solely prospective and can reflect the IRS's view with respect to similar transactions already executed.

Other ETF strategies

The Notice describes three additional ETF-related strategies and positions taken regarding the tax treatment of such strategies.

- **Box spread funds.** ETFs use combinations of options designed to produce a return similar to short-term interest rates and distribute options with unrealized gain in redemptions intended to qualify under Section 852(b)(6). The ETF holder does not have any current income or capital gains due to the application of Section 852(b)(6) and will recognize capital gains on the eventual disposition of the ETF shares. One variation also includes a separate transaction comprised of offsetting straddle positions in which the ETF distributes in-kind the unrealized gain straddle position and takes the position that a loss on the remaining straddle position is deductible although the offsetting gain is not recognized.
- **Record date strategies.** ETFs (parent ETFs) that invest in other ETFs (acquired ETFs) dispose of shares of an acquired ETF through an in-kind redemption shortly before the acquired ETF's dividend record date and maintain exposure to the same underlying index through another acquired ETF. The parent ETF takes the position that it avoids recognition of dividend income while generally maintaining its economic exposure to the same underlying index. The parent ETF shareholder does not have any current income, but the value of the dividend is economically reflected in the value of the parent ETF and will eventually be recognized as capital gains on the eventual disposition of the parent ETF shares.
- **RIC income test avoidance.** ETFs invest in assets, such as commodities or digital assets held either directly or through grantor trusts, that could generate non-qualifying income under the requirement that at least 90% of a RIC's gross income consist of specified types of qualifying income under Section 851(b)(2). The ETFs distribute appreciated assets through redemptions intended to qualify under Section 852(b)(6) and take the position that gain realized but not recognized on the redemption is not taken into account for purposes of the 90% gross income test.

Observations: These strategies discussed by the Notice illustrate Treasury and the IRS's concern that, in certain circumstances, rules applicable to ETF transactions may be used "not simply to operate an ETF in the normal course of carrying out its investment strategy, but instead to avoid the inclusion by the ETF or its shareholders of income or gain contemplated by" relevant provisions of the Internal Revenue Code. In light of the positions described in the recent guidance, if ETF sponsors and advisers are currently participating in or considering any of these transactions, they may wish to consider enhancing documentation to outline how such transactions fall within the ordinary course of an ETF's business.

Tax-aware fund strategies

The Notice describes three tax-aware fund strategies and positions taken regarding the tax treatment of such strategies.

- **Identified straddles with mixed character.** Certain pairs of transactions that differ in tax character may constitute a straddle under Section 1092. For example, a foreign currency forward contract gives rise to ordinary income/loss under Section 988, whereas a foreign currency regulated futures contract gives rise to 60% long-term and 40% short-term capital gain/loss under Section 1256. Using the identified straddle rules in Section 1092(a)(2) and always terminating the capital gain/loss transaction first, a fund takes the position that it recognizes predominantly ordinary losses and capital gains through the application of basis adjustments under the identified

straddle rules. The Notice also mentions a variant using notional principal contracts (NPCs) and futures contracts referencing the same equity index.

- **Same-day acquisitions and dispositions of foreign currency forward contracts.** Section 988(a)(1)(B) provides an election to treat foreign currency gain or loss on certain foreign currency contracts, including forwards, as capital gain or loss rather than its normal ordinary character. This election is made at the close of the day on which the transaction is entered into. Funds may enter into foreign currency forward contracts and terminate the transaction during the same trading day. The fund may then choose to make or not make the Section 988(a)(1)(B) election based on whether each transaction generated a gain or loss, resulting in ordinary loss and capital gains.
- **Selective NPC terminations.** Periodic and nonperiodic payments under certain swaps treated as NPCs for U.S. federal income tax purposes give rise to ordinary income or expense. Termination payments, on the other hand, generally give rise to capital gain or loss under Section 1234A. A fund may enter into an NPC and, shortly before a periodic or nonperiodic payment is due, choose whether to terminate based on whether the contract is in a gain or loss position. The fund takes the position that periodic or nonperiodic payments made by the fund result in ordinary expenses, but termination payments received by the fund result in capital gains.

Observations: The Notice distinguishes the above tax-aware fund strategies from long-standing, well-established techniques such as tax-loss harvesting and confirms that the ‘tax-aware’ or ‘tax-advantaged’ label is not itself a cause for concern. Funds and investors engaged in these strategies may consider submitting comments as requested under the Notice.

What’s next?

Treasury and the IRS are considering more guidance or other action on the transactions covered by the Notice. Potential actions could include regulations, notices, revenue rulings or other guidance, including designating a transaction as a transaction of interest or listed transaction. For the partnership variation of the Section 351 ETF conversion transaction, potential guidance could provide that the partnership contributions do not qualify for nonrecognition or could otherwise recharacterize the transactions. Any future guidance could apply prospectively or to transactions that already have occurred, depending on the circumstances and applicable authority. The Notice also indicates that the IRS may challenge an investment fund strategy on examination as inconsistent with existing law without waiting for additional guidance. Comments are requested on several issues, including whether transactions with different facts or economics warrant different treatment and how future guidance should be scoped to avoid affecting well-established market practices.

Let's talk

For a deeper discussion of how this guidance might affect your business, please contact:

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