The Great ETF Tax Swindle: The Taxation of In-Kind Redemptions

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Articles

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ABSTRACT

Since the repeal of the General Utilities doctrine over 30 years ago, corporations must recognize gain when distributing appreciated property to their shareholders. Regulated investment companies (RICs), which generally must be organized as domestic corporations, are exempt from this rule when distributing property in kind to a redeeming shareholder.

In-kind redemptions, while rare for mutual funds, are a fundamental feature of exchange-traded funds (ETFs). Because fund managers decide which securities to distribute, they distribute assets with unrealized gains and thereby significantly reduce the future tax burdens of their current and future shareholders. Many ETFs have morphed into investment vehicles that offer better after-tax returns than IRAs funded with after-tax contributions.

Furthermore, this rule is now being turbocharged. Some mutual fund families have created ETF classes of shares for some of their mutual funds, which permits the ETF shareholders to remove the gains attributable to the shareholders of the regular share class. Another firm acts as a strategic

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investor to assist mutual funds in eliminating their unrealized gains through contributions and redemptions. These transactions permit current and future fund shareholders to inappropriately defer tax on their economic gains and give ETFs and other mutual funds with ETF share classes a significant tax advantage over other investment vehicles.

This article considers various options that tax policymakers should consider to eliminate the ETF tax subsidy including explicitly extending this favorable tax treatment to all RICs by exempting fund-level gains from tax, repealing the exemption rule, limiting the amount of unrealized gains a fund can distribute, requiring ETFs to reduce the basis of their remaining property by the unrecognized gain of distributed property, or requiring ETFs to be taxed as partnerships.

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I. INTRODUCTION

In 2015 alone, the top 25 equity exchange-traded funds (ETFs) distributed tax-free securities with unrealized gains of almost $60 billion but did not distribute a single cent of taxable net capital gains.[1] Since the redeeming shareholders took a fair market value basis in the distributed securities, the gain in these securities disappeared.[2]

ETFs are generally taxed as corporations, but they and other regulated investment companies (RICs) enjoy a statutory exemption from the general rule that a corporation must recognize gain when it distributes appreciated property as a dividend or in redemption of its shares.[3] Although in-kind redemptions are rare for closed-end funds and mutual funds, they are a fundamental characteristic of ETFs.[4]

It is well known that ETFs strategically distribute low-basis securities to redeeming shareholders to substantially reduce or eliminate future fund-level capital gains.[5] This gambit permits ETFs to avoid any fund-level gains and fund shareholders to indefinitely defer their gains until a sale of their shares. Furthermore, through this mechanism, ETFs can convert short-term gains at the fund level into long-term gains at the shareholder level. Consequently, many equity ETFs held directly give taxable shareholders higher after-tax returns than if they were held in a nondeductible IRA. This gives ETFs a significant tax advantage over closed-end funds, mutual funds, foreign investment companies, and other collective investment vehicles and is certainly a major factor in their meteoric rise over the last decade.[6]

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1. *See* Annex A. The fund data in Annex A is drawn from the funds' annual reports covering taxable years beginning in 2015. All sources on file with author.

2. *See* 26 U.S.C. § 1012 (2012).

3. *Id.* § 852(b)(6). All other corporations must recognize gain upon the distribution of appreciated property to their shareholders as a dividend or in redemption of their shares. *See id.* § 311(b).

4. *See infra* Part II.A. At the end of 2015, mutual funds held approximately $15.7 trillion of the total $18.1 trillion held by U.S. investment companies. INV. CO. INST., 2016 INVESTMENT COMPANY FACT BOOK 9 fig.1.1 (56th ed. 2016), www.ici.org/pdf/2016_factbook.pdf [hereinafter FACT BOOK].

5. David J. Abner & Gary L. Gastineau, *ETFs v. Mutual Funds: Tax Efficiency*, FIDELITY, https://www.fidelity.com/learning-center/investment-products/etf/etfs-tax-efficiency (last visited Feb. 27, 2017) ("For the most part, ETF managers are able to manage the secondary market transactions in a manner that minimizes the chances of an in-fund capital gains event.").

6. *See* Chris Dieterich, *The ABCs of ETF Tax-Efficiency; Don't Forget ETFs Aren't Exempt*, BARRON'S (Dec. 28, 2015, 11:10 AM), http://blogs.barrons.com/focusonfunds/2015/12/28/the-abcs-of-etf-tax-efficiency-dont-forget-etfs-arent-exempt ("Tax efficiency has been a major driver behind the success of the nearly $2.2 trillion ETF market."); *infra* Part II.A (discussing ETFs).

For the first 60 years of the U.S. corporate income tax, a corporation did not generally recognize gain or loss on the distribution of property to its shareholders as a dividend, in redemption of its stock, or pursuant to a liquidation.[7] This treatment followed the holding of the venerable case *General Utilities & Operating Co. v. Helvering*, in which the Supreme Court held that a corporation did not recognize gain on the distribution of appreciated property as a dividend.[8]

The first major statutory reversal of the *General Utilities* doctrine occurred in 1969 when Congress enacted former § 311(d)(1) to require a corporation to recognize gain on the distribution of appreciated property to a shareholder in a redemption of its shares.[9] In the same legislation, but without any discussion in the legislative history, Congress exempted mutual funds from the gain recognition requirement.[10] Consequently, a mutual fund could continue to distribute appreciated property tax-free to its shareholders in redemption of their shares.

In 1984, additional amendments to former § 311(d) further curtailed the scope of the *General Utilities* doctrine.[11] Finally, in 1986, all of the statutory exceptions to gain recognition in former § 311(d) were eliminated. In their place, Congress enacted § 311(b), which requires corporations to recognize gain on the distribution of appreciated property to their shareholders, whether the corporation distributes property pro rata or in redemption of the shares of a particular shareholder.[12] Without much

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7. 26 U.S.C. § 311(a)(2) (1954) (amended in 1969) (stating that a corporation does not recognize gain or loss on the distribution of property); *id.* §§ 336(a), 337(a) (stating that a corporation does not recognize gain or loss on the distribution of property in liquidation or the sale of property with a 12-month period of adoption of liquidation). Notwithstanding the general non-recognition rules, gain was required to be recognized on the distribution of LIFO inventory and property with liabilities greater than basis, and on the distribution of installment obligations in liquidations. *Id.* §§ 311(b)–(c), 336.

8. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935). The *General Utilities* doctrine was originally codified in § 311(a) of the Internal Revenue Code of 1954, which remains in the Code but does not apply if the adjusted basis of the distributed property exceeds its FMV. 26 U.S.C. § 311(b) (2012).

9. Tax Reform Act of 1969, Pub. L. No. 91-172, sec. 905(a), § 311(d)(1), 83 Stat. 487, 713 (amended 1986). The legislative history clarifies that gain recognition was required whether the redemption was treated as an ordinary distribution under § 301 or an exchange under § 302(a). H. R. REP. NO. 91-782, at 333 (1969).

10. Sec. 905(a), § 311(d)(2)(G), 83 Stat. at 714.

11. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, sec. 54, § 311, 98 Stat. 494, 568. For a discussion, see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.22 (5th ed. 1987).

12. Tax Reform Act of 1986, Pub. L. 99-514, sec. 631(c), § 311, 100 Stat. 2085, 2272 (codified as amended at 26 U.S.C. § 311 (2012)). Section 311(b) applies to distributions described in §§ 301–07, which include ordinary distributions (generally treated as dividends) under § 301 and distributions in redemption of a corporation's shares that are treated as exchanges under § 302(a). An important exception to this rule is § 355, which

discussion, the exemption from gain recognition for in-kind distributions by mutual funds was maintained, but it simply migrated from Subchapter C to Subchapter M as § 852(b)(6).[13]

Various arguments have been advanced to justify exempting investment companies from § 311(b). One traditional justification is tied to a long-standing, non-tax relief valve for mutual funds: the ability of a mutual fund, in the case of significant shareholder redemption requests, to distribute assets instead of cash to a redeeming shareholder so as not to be forced to sell them at "fire sale" prices.[14] If a mutual fund recognized gain upon the in-kind distribution of its assets, the fund's capital gains might increase, and the fund might have to sell additional assets to generate cash with which to make its required distributions to avoid entity-level tax.[15] The additional sales (again perhaps at fire-sale prices) might injure remaining mutual fund shareholders and potentially increase systemic market distress if the redemptions were made due to market distress.

Another argument is that since mutual funds are intended to be pass-through entities, i.e., not subject to entity-level taxation, it is incompatible with pass-through taxation principles to impose entity-level taxation on the distribution of appreciated assets.[16] For instance, entities taxed as partnerships and trusts do not generally recognize gain or loss when they distribute appreciated property to their owners.[17] Finally, repealing this rule could thwart the expansion of ETFs, which have grown in popularity

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permits a corporation to distribute stock or securities of a controlled corporation to its shareholders in a spin-off, split-up, or split-off without the recognition of gain or loss. 26 U.S.C. § 355(c) (2012). Another exception is for property distributed to an 80 percent-or-more corporate shareholder in a corporate liquidation. *Id.* § 337(a).

13. *Compare* 26 U.S.C. § 311(d)(2)(E) (1982) (amended 1986), *with* sec. 631(e)(11), § 852(b), 100 Stat. at 2274 (codified as amended at 26 U.S.C. § 852(b)(6) (2012)).

14. Michael S. Piwowar, Comm'r, SEC, Remarks at the 2015 Mutual Funds and Investment Management Conference (Mar. 16, 2015).

15. *See* SUSAN A. JOHNSTON & JAMES R. BROWN, JR., TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS ¶ 3.06[2][c] (2016).

16. When the exemption for mutual funds from former § 311(d) was enacted, there was no discussion in the legislative history for the justification of the mutual fund exclusion, although a contemporary commentator suggested that justification for the legislation "is probably to be found in the general legislative purpose to minimize the tax on regulated investment companies on the theory that they are but conduits." Clifford L. Porter, *Redemption of Stock with Appreciated Property: Section 311(d)*, 24 TAX LAW. 63, 79 (1970).

17. *See* 26 U.S.C. § 643(e)(1) (2012) (trusts and estates); *id.* § 731 (partnerships). Partnership taxation has mechanisms that ensure that the unrealized gain in distributed property is eventually taxed. *See infra* Part III.E.7.

because they have ameliorated certain structural weaknesses of closed-end and mutual funds.[18]

Upon closer examination, none of these justifications holds water.[19] It is clear that Congress did not enact this rule with ETFs (currently the main beneficiary of this rule) in mind: when the exception for mutual funds originally appeared in 1969 and was subsequently moved to Subchapter M in 1986, ETFs did not yet exist—the first ETF appeared only in 1993. Section 852(b)(6) was intended to apply only to mutual funds, which rarely distributed property in kind.[20]

Various market mechanisms have developed to turbocharge this loophole. At least two investment managers, Vanguard and Eaton Vance, offer funds with a special ETF share class, which permits the funds to distribute low-basis securities when the ETF shares are redeemed and thereby eliminate future taxable gains for the mutual fund shareholders.[21] Another firm makes strategic investments in mutual funds with the intention that it will be redeemed with appreciated assets.[22] These investments and the related redemptions permit a fund to eliminate the fund's unrealized gains on a tax-free basis, which permits remaining shareholders to indefinitely defer their economic gains until they liquidate their investments in the fund.[23] These structured investments are clearly contrary to the intent of Subchapter M and sound tax policy principles. Because funds that are held in taxable accounts are largely owned by high-net-worth taxpayers, this rule also bestows an untoward benefit on high-net-worth taxpayers.

The ability to distribute assets in kind without the recognition of gain disproportionately benefits ETFs over closed-end funds, mutual funds, and other U.S. and foreign collective investment vehicles. If the benefits of ETFs—low costs and the ability to trade at prices close to Net Asset Value (NAV) through the day—are truly valuable innovations, ETFs will continue to thrive without the inappropriate tax subsidy of § 852(b)(6).

The larger problem is that Subchapter M, which governs the taxation of RICs such as mutual funds and ETFs, is deficient in tracking and

18. *See* William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 76–86 (2008).

19. *See infra* Part III.

20. The IRS has extended the non-recognition rule of § 852(b)(6) to closed-end funds in various private letter rulings. *See infra* Part III.A.

21. *See infra* Part II.D.

22. *See infra* Part II.D.

23. These investments may have additional benefits to the funds as well, such as reducing trading costs for redemptions and subscriptions and assisting in managing a fund's cash drag. They are discussed *infra* at Part II.D.

assigning a fund's taxable gains to the shareholders who have economically benefited from them. A fund's shareholders can be temporarily overtaxed or undertaxed, and § 852(b)(6) can significantly exacerbate this problem. Section 852(b)(6) is classified as a tax expenditure, but somewhat surprisingly, the revenue loss is not quantified.[24]

This article explores various alternatives that tax policymakers should consider in revising Subchapter M, including: exempting from tax all fund-level capital gains of RICs, repealing § 852(b)(6), requiring redeeming shareholders to take a carryover basis in distributed securities, tying the basis of the distributed securities to the percentage of shares redeemed, reducing the basis of remaining securities by the unrecognized gain in the distributed securities, and finally, revising Subchapter M to incorporate certain principles of partnership taxation for ETFs and possibly mutual funds and closed-end funds.[25]

Part II gives a brief overview of the different types of investment companies that are subject to Subchapter M and delineates some of the regulatory and structural differences between them. It examines the tax and accounting treatment of in-kind redemptions, describes how this information is disclosed to investors, and demonstrates how the failure to tax in-kind redemptions permits current shareholders to inappropriately defer tax on their economic gains. Part III discusses various alternatives to the current regime and concludes that tax policymakers should either repeal § 852(b)(6) or require ETFs to be subject to provisions similar to those of Subchapter K.

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24. JOINT COMM'N ON TAXATION, 115TH CONG., JCX-3-17, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2016–2020 25 (2017). It is listed as a tax expenditure for which quantification is not available.

25. This article extends other critiques of Subchapter M. *See, e.g.*, Samuel D. Brunson, *Mutual Funds, Fairness, and the Income Gap*, 65 ALA. L. REV. 139, 160 (2013) (recommending that investors be able to exclude up to ten percent of their dividend income from mutual funds from the investors' taxable income); John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. LEGAL ANALYSIS 591, 614–18 (2009) (discussing a wide array of mutual fund reforms); Steven Z. Hodaszy, *Tax-Efficient Structure or Tax Shelter? Curbing ETFs' Use of Section 852(b)(6) for Tax Avoidance*, 70 TAX LAW. 537, 599–605 (2017) (arguing that ETFs should be required to reduce the basis of their remaining securities by the unrecognized gain of distributed securities); Lee A. Sheppard, *ETFs as Tax Shelters*, 130 TAX NOTES 1235, 1240 (2011) (critiquing § 852(b)(6)); Shawn P. Travis, *The Accelerated and Uneconomic Bearing of Tax Burdens by Mutual Fund Shareholders*, 55 TAX LAW. 819, 853–57 (2002) (detailing scenarios under which Subchapter M can result in acceleration of tax for fund shareholders and arguing that fund shareholders should not be taxed on reinvested capital gains, but should only be taxed when shares are sold or non-capital gain dividends received).

II. INVESTMENT COMPANIES

This Part describes the various categories of RICs in the United States and surveys keys aspects of the U.S. tax regime applicable to RICs.

An investment company falls under the rubric of collective investment vehicle, which generally refers to a regulated entity that pools capital from a multitude of investors and acquires and manages investment assets such as stocks, bonds, commodities, and real estate on behalf of the investors.[26] The investment companies that are subject to the provisions of the Investment Company Act of 1940 (the "1940 Act")[27] are "face-amount certificate companies," "unit investment trusts," and "management companies."[28] The most important category, management companies, consists of open-end funds (mutual funds and ETFs) and closed-end funds.[29] At the end of 2015, the total $18.11 trillion investment company net assets were held (in billions) as follows (percent of the total in parenthesis):[30]

Mutual Funds	**Closed-End Funds**	**ETFs**	**UITs**	**Total**
15,652 (86%)	261 (1.4%)	2,100 (11.5%)	94 (0.5%)	18,107

26. The term "collective investment vehicle" is more often used in the international context. *See* ORG. FOR ECON. CO-OPERATION & DEV., THE GRANTING OF TREATY BENEFITS WITH RESPECT TO THE INCOME OF COLLECTIVE INVESTMENT VEHICLES 1 (2010), https://www.oecd.org/tax/treaties/45359261.pdf. This definition excludes private vehicles, such as hedge funds and private equity funds. U.S. treaties typically use the similar term "pooled investment vehicle" (PIV). *See, e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-U.K., art. 10, para. 10(b), July 24, 2001, T.I.A.S. No. 13161 (defining PIV). The terminology has recently become part of the Internal Revenue Code. *See* 26 U.S.C. § 897(k)(3)(D) (2012) (defining collective investment vehicle).

27. The 1940 Act regulates "investment companies." 15 U.S.C. § 80a-3(a)(1) (2012) (defining investment company to mean any issuer that holds itself out as being engaged primarily in the business of investing or trading in securities). Certain entities that would otherwise be classified as investment companies, such as hedge funds and private equity funds, are not subject to the provisions of the 1940 Act because of statutory exemptions for private companies. *See id.* § 80a-3(c)(1) (exempting from the definition of investment company any issuer whose outstanding securities are owned by 100 or fewer persons and whose securities are not publicly offered); *id.* § 80a-3(c)(7) (exempting from the definition of investment company any issuer whose securities are owned by qualified purchasers and whose securities are not publicly offered); *see also Investment Company Registration and Regulation Package*, SEC, https://www.sec.gov/investment/fast-answers/divisionsinvestmentinvcoreg121504htm.html (last modified Dec. 21, 2004).

28. 15 U.S.C. § 80a-4(1)–(3) (2012) (classifying an investment company as either a "face-amount certificate company," "unit investment trust," or "management company"). This article does not discuss face-amount certificate companies.

29. 15 U.S.C. § 80a-5(a)(1)–(2) (2012).

30. FACT BOOK, *supra* note 4, at 9 fig.1.1.

An investment company generally pursues some version of either an active management strategy, which entails selecting investments based on the manager's view of their potential for future appreciation (or depreciation), or a passive strategy in which the fund holds securities that mimic the returns of an index, such as the S&P 500, Wilshire 5000, or Dow Jones Industrial Average. An active fund manager strives to generate returns greater than the returns of a particular benchmark, whereas a passive fund manager attempts to match the returns of the relevant index as closely as possible. In recent years, given the superior performance of passive investment funds over actively managed funds,[31] investors have moved significant assets from active funds to passive funds, especially ETFs, which have traditionally focused on passive investment strategies.[32]

A. UITs and Management Companies

There are two basic types of investment companies, Unit Investment Trusts (UITs) and management companies,[33] which in turn are divided into open-end funds (mutual funds and ETFs) and closed-end funds.[34]

UITs are organized under a trust indenture, do not have a board of directors, and issue only redeemable securities that represent an undivided interest in a unit of specified securities.[35] A UIT is formed by a sponsor that contributes assets to a trust pursuant to a trust indenture, which designates the trustee, sponsor, and evaluator that administer the trust's

31. As of June 30, 2016, 92 percent of large-cap funds underperformed the S&P 500 over the preceding five years. For other market segments, the percentages were close to or often exceeded 90 percent. AYE M. SOE & RYAN POIRIER, SPIVA U.S. SCORECARD, S&P DOW JONES INDICES 4 (2016).

32. *See, e.g.*, John Authers & Chris Newlands, *Exchange Traded Funds: Taking Over the Markets*, FIN. TIMES (Dec. 5, 2016), https://www.ft.com/content/a54e75d4-b7f9-11e6-ba85-95d1533d9a62 (noting that five of the world's seven most heavily traded equity securities are ETFs and $130.7 billion flowed out of all US mutual funds while $240 flowed into U.S. ETFs over the last 12 months); Robin Wigglesworth & Stephen Foley, *Active Asset Managers Knocked by Shift to Passive Strategies*, FIN. TIMES (Apr. 11, 2016), https://www.ft.com/content/2e975946-fdbf-11e5-b5f5-070dca6d0a0d (reporting that 40 percent of the assets of U.S. equity vehicles are invested passively, up from 18.8 percent ten years ago; and for 2015, active equity funds had $3.40 billion net outflow while equity ETFs increased by $7.6 billion).

33. 15 U.S.C. § 4(1)–(3) (2012).

34. *Id.* § 5(a)(1)–(2).

35. *Id.* § 4(2). UITs represented in 2016 only about 0.5 percent of the total investment company net assets, and the total value of assets held by UITs is the same value as it was in 1998. FACT BOOK, *supra* note 4, at 9 fig.1.1. The total value of UITs declined significantly in the 2000s, reaching a low of $29 billion in 2008, but rebounded to $101 billion in 2014. *Id.*

operations.[36] The UIT issues a fixed number of units to the depositor, which in turn distributes the units through broker-dealers, registered investment advisers, and certified financial planners.[37] A unitholder can dispose of its units either by selling them on an exchange or requesting redemption from the UIT.[38] In-kind redemptions are generally permitted if the unitholder tenders a significant number of units.[39]

If a UIT can vary the investment of the unitholders,[40] it qualifies as a business entity[41] and can elect to be treated as a corporation for tax purposes.[42] To be a RIC for tax purposes, a UIT must be a domestic corporation.[43] To ensure that a UIT is treated as a business entity, the trust is drafted to permit the trustee to vary the trust's investments, for example, by selling or buying securities.[44]

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36. The trust indenture must satisfy requirements set forth in § 26 of the 1940 Act. 15 U.S.C. § 26 (2012); *see, e.g.*, Elkhorn Unit Tr., Series 1, Prospectus (Form S-6/A) exhibit 1.1.1, art. II, secs. 2.01, 2.03 (Jan. 14, 2015).

37. Elkhorn Unit Tr., Series 5, Prospectus (Form S-6/A) 37–38 (Aug. 4, 2015) (describing distribution of units).

38. *See, e.g.*, *id.* at 29–30 (describing how to sell units, including redeeming units).

39. *See, e.g.*, *id.* at 30 (describing in-kind redemptions).

40. *See id.* If the UIT cannot vary the investment of the unitholders, it will be classified as a trust for tax purposes. Treas. Reg. § 301.7701-4(c)(1) (as amended in 1996). The trust structure is used when the UIT could not otherwise satisfy the diversification requirements in Subchapter M or does not invest primarily in securities and thus does not constitute an investment company under the 1940 Act. The sponsors take the position that the trust is a grantor trust and therefore the unitholders hold an undivided interest in the trust property. A grantor trust is not subject to entity-level taxation, but instead each trust unitholder must recognize its pro rata share of the trust's income and gains. *See, e.g.*, JPM XF Physical Copper Tr., Prospectus (Form S-1) amend. no. 6, 95 (Jan. 17, 2013) (discussing the taxation of the trust and its beneficiaries).

41. Treas. Reg. § 301.7701-4(c)(1).

42. Treas. Reg. § 301.7701-3(a) (as amended in 1996) (stating that a business entity can elect tax classification). A UIT that is treated as a business entity may also be classified as a corporation if it is a publicly traded partnership under § 7704(a). A partnership is publicly traded if partnership interests are traded on an established securities market. 26 U.S.C. § 7704(b)(1) (2012). Although most investment partnerships would satisfy the qualifying income test of § 7704(c) and therefore would not be treated as corporations, the qualified income exception does not apply to a partnership that would be described in § 851(a) if the partnership were a domestic corporation. *Id.* § 7701(c)(3). A partnership interest is publicly traded on a secondary market if the interests are quoted by a broker or dealer or any person stands ready to effect a buy or sell transaction at the quoted price. Treas. Reg. §§ 1.7704-1(c)(2)(i)–(ii) (1995). Under the check-the-box regulations, an entity filing an election to be treated as a REIT is deemed to have made an election to be treated as an association. Treas. Reg. § 301.7701-3(c)(v)(B). There is no similar deemed election for RICs. *See* Letter from Keith Lawson, Inv. Co. Inst., to Cynthia Morton, IRS (June 26, 2012), https://www.ici.org/pdf/26272.pdf. This issue is most relevant for non-publicly traded entities.

43. 26 U.S.C. § 851(a) (2012).

44. *See, e.g.*, Elkhorn Unit Tr., *supra* note 36, exhibit 1.1.1, art. 3, sec. 3.07(xii). For example, the Elkhorn Unit Trust provides:

An open-end fund is a management company that offers for sale or has outstanding *redeemable shares*, which are shares that entitle the holder to receive from the issuer "his proportionate share of the issuer's current net assets, or the cash equivalent thereof."[45] The oldest and most popular open-end fund is the mutual fund, which continually offers its shares for sale at the fund's NAV, and continually offers to purchase or redeem its shares at the fund's NAV.[46] Because a mutual fund's NAV is generally determined only at the end of the day, a shareholder requesting to buy or redeem shares during the day will not know the price he will pay or receive until the end of the day. This time lag makes traditional mutual funds poor vehicles to implement rapid trades based on breaking news.

Because a mutual fund must pay redemption proceeds within seven days,[47] a fund must generally hold some relatively liquid securities, including cash, to satisfy redemption requests.[48] Holding cash can cause a

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> If the Trust is a RIC, that such sale is necessary or advisable (A) to maintain the qualification of the Trust as a regulated investment company or (B) to provide funds to make any distribution for a taxable year to avoid imposition of any income or excise taxes on the Trust or on undistributed income in the Trust. . . .

Id.

45. 15 U.S.C. §§ 80a-2(a)(32), 80a-5(a)(1) (2012) (defining redeemable security and open-end company, respectively).

46. 17 C.F.R. § 270-22c-1(a) (2017) (requiring redemption or purchase price to be at the current NAV which is next computed after the redemption or purchase request); *id.* § 270-22c-1(b)(1) (requiring NAV to be computed at least once per day at a time determined by the board). For a discussion of the nuances of determining NAV, see James E. Anderson et. al., *Purchase and Sales of Mutual Funds Shares*, *in* 1 MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATIONS 16-1 (2015).

47. 15 U.S.C. § 80a-22(e) (2012) (stating that a fund must make payment to a redeeming shareholder within seven days). The market practice is that redemptions proceeds are paid sooner, sometimes the next day. *See* Investment Company Liquidity Risk Management Programs, 81 Fed. Reg. 82,142, 82,143 (Nov. 18, 2016).

48. The SEC issued, in 2016, comprehensive rules that address liquidity issue for funds and impose requirements that most funds implement and adopt a written liquidity risk management program as well as reporting and disclosure of illiquid assets held by management companies. Investment Company Liquidity Risk Management Programs, 81 Fed. Reg. at 82,142. Pursuant to these rules, no fund can acquire any illiquid investment if the fund would have more than 15 percent of its net assets in illiquid investments. 17 C.F.R. § 270-22e-4(b)(iv) (2017). If a fund's illiquid assets exceed 15 percent of its net assets, it is subject to certain disclosure and reporting requirements, and the fund is required to develop a plan to bring illiquid assets below the 15 percent threshold or to determine that holding such assets continue to be in the best interest of the fund. *Id.* An "illiquid investment" is "any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment." *Id.* § 270-22e-4(a)(viii). Prior to the issuance of these rules, the 15 percent threshold was merely a guideline. *See* Revisions of Guidelines to Form N-1A, Exchange Act, 57 Fed. Reg. 9828 (Mar. 20, 1992) (revising guidelines of Form N-1A to permit mutual fund to invest up to 15 percent of its assets in illiquid assets). Modern mutual funds may have access to liquidity facilities organized by the investment manager.

fund's return to lag behind the relevant benchmark if the return on cash is less than the return on the fund's securities. The lag can be quite pronounced if the fund's underlying investments generate returns greater than the returns on the cash.

Another consequence of issuing immediately redeemable securities is that redeeming shareholders can impose significant tax and trading costs on non-redeeming shareholders. When a fund experiences significant net redemptions (redemptions in excess of purchases), the fund can be forced to sell assets to generate the cash necessary to pay the redemption proceeds. These sales can generate taxable gains, which are attributed under Subchapter M to the remaining shareholders.[49] The issuance of shares, maintenance of shareholdings, incurrence of trading costs, and the payment of the redemption proceeds generate additional administrative costs that are also borne by the fund and perforce by the remaining shareholders.[50]

Closed-end funds differ from mutual funds in that closed-end funds do not issue redeemable securities.[51] Closed-end funds raise capital in an initial or secondary public offering of their shares. Once the capital is committed to a fund, current shareholders desiring to liquidate their interests in the fund must sell their shares and investors desiring to own shares of the fund must acquire their shares on an exchange at a price determined by the market.[52] As long as an orderly market is maintained in the fund shares, shareholders can exit or buy any time an exchange is open, and consequently, the fund share prices should incorporate any market moving information. At the inception of the investment companies in the 1920s, closed-end funds had accumulated much more capital than mutual funds, but by the mid-1930s mutual funds considerably narrowed the

49. *See infra* Part II.B.

50. GARY L. GASTINEAU, THE EXCHANGE-TRADED FUNDS MANUAL 6 (2d. ed. 2010).

51. 15 U.S.C. § 80a-5(a)(2) (2012) (defining closed-end company to be any management company that is not an open-end company).

52. Some funds offer liquidity through tender offers, and new shares can be offered through rights offerings. The rules for tender offers by closed-end funds are found in 17 C.F.R. § 270-22c-3 (2017). *See* May Joan Hoene, *A History and Overview of Mutual Fund Regulation*, *in* 1 MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATIONS, *supra* note 46, at 1A-1; *see, e.g.*, New Ir. Fund, Inc., Amended and Restated Application for an Order of Exemption under § 17(b) of the Investment Company Act of 1940 (40-APP/A) (Dec. 23, 2016) (requesting permission to permit in-kind tender offer).

difference.[53] In recent years, ETFs have totally eclipsed closed-end funds in assets under management (AUM).[54]

Because closed-end funds do not issue redeemable securities, they can be more appropriate vehicles for holding relatively illiquid portfolios, such as foreign securities, foreign bonds, and certain high-yield bonds.[55] Consequently, the SEC has exempted closed-end funds from the rules regarding the maximum percentage of illiquid assets that can be held by a management company.[56]

One reason for the relative lack of popularity of closed-end funds is that the shares often trade at a discount or, less frequently, a premium to NAV. These discounts have been observed since the emergence of investment companies in the United States almost 100 years ago.[57] Many academic studies have attempted to explain the gap between the market value of the shares and a fund's NAV.[58] Importantly, there is no easy mechanism for investors or fund managers to eliminate the pricing disparity. This could preclude closed-end funds from being used as hedging vehicles as their trading price could deviate substantially from the fund's NAV depending on the demand for the shares.[59]

The frequent deviations from NAV of the share price of closed-end funds and the end-of-trading-day pricing of open-end funds helped to stimulate the creation of ETFs, the most important development in investment companies in the last 60 years. From comprising a quite modest 0.3 percent ($16 billion) of investment company net assets in 1998, ETFs at the end of 2015 comprised 12 percent ($2.1 trillion) of net assets.[60]

The first ETF, Standard & Poor's Depositary Receipts (SPDRs) Trust, Series 1 ("SPDRs S&P 500 Trust"), was formed as a UIT in January

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53. In 1929, closed-end funds comprised approximately 90 percent of management investment companies proper and approximately 95 percent of the assets. H.R. DOC. NO. 70, at 27 (1939). Seven years later, these percentages had dropped to approximately 74 percent and 71 percent respectively. *Id.*

54. FACT BOOK, *supra* note 4, at 9 fig.1.1.

55. *See* Wendell M. Faria, *Closed-End Investment Companies, in* 1 MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATION, *supra* note 46, at 33-12.

56. Investment Company Liquidity Risk Management Programs, 81 Fed. Reg. 82,142, 82,152 (Nov. 18, 2016) (effective Jan. 17, 2017) (excluding closed-end companies from the liquidity rules).

57. H.R. DOC. NO. 70, at 320–23.

58. Faria, *supra* note 55, at 33-9 (listing various suggested explanations for the discount phenomenon); Charles Lee et al., *Anomalies: Closed End Mutual Funds*, 4 J. ECON. PERSP. 153, 154–55 (1990) (noting that the pricing of closed-end funds presents several questions).

59. RICHARD A. FERRI, THE ETF BOOK 12 (2008).

60. FACT BOOK, *supra* note 4, at 9 fig.1.1.

1993.[61] All recent ETFs are organized as open-end funds, but require exemptive relief from various provisions of the 1940 Act.[62] ETFs raise capital by issuing shares in creation units, which typically consist of a large number of shares, for example, 50,000, in exchange for a designated portfolio of securities plus a small cash payment.[63]

ETFs permit redemptions, but the redemptions are generally paid in kind—that is, with securities of the ETF, and not in cash. Importantly, generally only certain large institutional shareholders, known as authorized participants (APs), are permitted to contribute securities in exchange for shares and request securities in redemption of shares.[64] Both the contributor and redeemer are charged a transaction fee.[65]

Non-AP shareholders must purchase and sell their shares on an exchange at the market price, which reflects the supply and demand for the ETF shares. It is possible that the ETF share price can deviate from NAV, but the creation and redemption process by APs helps to ensure that the exchange price of the ETF does not deviate significantly from the fund's NAV.[66] For instance, if the exchange price were greater than the NAV, an AP could purchase the underlying securities and contribute them to the ETF at NAV in exchange for shares that could be subsequently sold for a profit. If the exchange price were less than NAV, the AP could

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61. For an overview of the historical development of ETFs, see JOANNE M. HILL ET AL., A COMPREHENSIVE GUIDE TO EXCHANGED-TRADED FUNDS (ETFS) 14–16 (2015), http://www.cfapubs.org/doi/pdf/10.2470/rf.v2015.n3.1; GASTINEAU, *supra* note 50, at 25–28; Birdthistle, *supra* note 18, at 76–78.

62. *See infra* text accompanying notes 69–70. The term ETF is applied in the marketplace to investment vehicles that are not RICs or subject to Subchapter M, including structured notes, partnerships, and securitized commodity products. *See What Are the Five ETF Structures?*, VANGUARD https://advisors.vanguard.com/VGApp/iip/site/advisor/etfcenter/article/ETF_FiveStructures (last visited Feb. 27, 2017); *see, e.g.*, Direxion Shares ETF Tr. II, Prospectus (Form S-1) (Dec. 14, 2016) (indicating that a commodity pool not subject to the 1940 Act is taxed as a partnership). Unless otherwise stated, this article focuses solely on ETFs that are RICs. In 2008, when the SEC proposed regulations codifying exemptive relief for ETFs from provisions of the 1940 Act, it stated that it had not received an application for exemptive relief for an ETF formed as a UIT since 2002. Exchange-Traded Funds, 73 Fed. Reg. 14,618, 14,623 (Mar. 11, 2008). The reason is that open-end funds offer more flexibility than UITs, including the ability to lend securities and reinvest dividends. *Id.*

63. For a discussion of the creation procedures, see, for example, SPDR S&P 500 ETF Tr., Prospectus (485BPOS) 40–44 (Jan. 19, 2017). The cash component is the difference between the NAV of a creation unit and the market value of the deposit securities. *Id.* at 55. Some ETFs will issue shares in exchange for cash. *See* HILL ET AL., *supra* note 61, at 24.

64. SPDR S&P 500 ETF Tr., *supra* note 63, at 40.

65. *Id.* at 45 (indicating that the transaction fee is currently $3,000).

66. A recent study has found evidence of significant mispricing in certain ETFs. Antti Petajisto, *Inefficiencies in the Pricing of Exchange-Traded Funds*, 73 FIN. ANALYSTS J. 24, 25 (2017).

purchase the shares and then request redemption from the ETF in exchange for securities that could be sold for a profit.[67]

ETFs can mitigate many of the structural shortcomings of mutual and closed-end funds. The redemption and creation process helps to ensure that the market price of the ETF shares does not vary substantially from NAV, thus avoiding the discounts and premiums often arising in closed-end funds. Non-AP shareholders generally have instant liquidity at real-time NAV, thus eliminating the end-of-day pricing of mutual funds, albeit at the cost of executing the trades through a broker. The costs associated with acquiring, selling, and redeeming shares are borne by the shareholders engaging in such transactions and not by the non-redeeming shareholders.

Moreover, because ETFs generally make in-kind redemptions, an ETF does not have to sell securities to generate cash, and thus it potentially avoids generating taxable gains for non-redeeming shareholders. Moreover, as discussed below, funds can strategically use the redemption mechanism to eliminate their capital gains and thereby permit non-redeeming shareholders to defer taxes on their economic gains. These factors, plus the growing investor demand for low-cost, passive investing strategies, have driven the explosive demand for ETFs.[68]

ETFs have certain characteristics of mutual funds and closed-end funds and do not fit squarely within the regulatory regime of either. Consequently, ETFs need regulatory exemptive relief from various provisions of the 1940 Act and the Securities Act of 1933 (the "1933 Act") to be publicly offered.[69] In particular, ETFs generally require exemptions from the one-class-of share requirement, the requirement to issue shares at NAV, and the exemption from prohibited transactions with affiliates.[70]

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67. *See* HILL ET AL., *supra* note 61, at 25–27 ("[T]he back-and-forth creation/redemption mechanism is key to keeping the price of an ETF in a tight range around the NAV of the portfolio of securities it holds."). This mechanism is not perfect and there have been instances in which a significant difference has arisen between an ETF's NAV and its share price. *See, e.g.*, Nicole Bullock & Dan McCrum, *Rapid Rise of ETFs Sparks Growing Pains*, FIN. TIMES (Dec. 5, 2016), https://www.ft.com/content/cf69b382-bade-11e6-8b45-b8b81dd5d080 (noting various notable instances over the last three years in which market volatility had led to significant divergences of ETF share price and NAV and concerns that redemption process may exacerbates losses when market in underlying securities is shallower than market in ETF shares).

68. Authers & Newlands, *supra* note 32. This growth, however, may be a harbinger of future problems. *See* John Bogle, *The Lessons We Must Take from ETFs*, FIN. TIMES (Dec. 11, 2016), https://www.ft.com/content/f406d50c-bbcf-11e6-8b45-b8b81dd5d080 (critiquing high trading activity of ETFs and suggesting that such activity may ultimately harm shareholders).

69. 15 U.S.C. § 80a-6(c) (2012) (authorizing the SEC to exempt transactions, persons, and securities from the requirements of the 1940 Act).

70. *See, e.g.*, USAA ETF Tr., Exemptive Order Application for Asset Management Company (40-APP) 26–38 (Aug. 18, 2016) (requesting exemptive relief from:

The Securities and Exchange Commission (SEC) proposed rules in 2008 that would make certain exemptions for ETFs automatic, but they have not been finalized.[71]

Although UITs, mutual funds, closed-end funds, and ETFs have distinct mechanisms for raising capital from investors and providing for investor exits, all are subject to the same tax regime of Subchapter M, which is described next.[72]

B. Overview of Investment Company Taxation

RICs and their shareholders are taxed under Subchapter M,[73] which reflects two fundamental tax policy goals: to exempt RICs from entity-level tax and to pass through the character of most mutual fund income to its shareholders. Subchapter M is a pass-through regime in some ways like the pass-through regimes applicable to S corporations and partnerships, but it implements pass-through taxation differently than either. Both partnerships and S corporations are generally exempt from entity-level taxation,[74] but their owners are taxed annually on their share of the entity's income.[75] In contrast, RICs are subject to entity-level taxation, but because RICs can deduct dividends paid, RICs generally avoid entity-level tax by paying out all their income and gains as deductible dividends.

To qualify as a RIC under Subchapter M, an entity must be a U.S. corporation that is registered under the 1940 Act as either a management

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§ 2(a)(32) (definition of redeemable security); § 5(a)(1) (definition of open-end company); § 22(d) and Rule 22c-1 (redemption at NAV requirement); § 17(a)(1) (dealings in the fund shares by affiliates); § 22(e) (seven-day limit on the right of redemption)).

71. Exchange-Traded Funds, 73 Fed. Reg. 14,618 (proposed Mar. 11, 2008), www.sec.gov/rules/proposed/2008/33-8901fr.pdf.

72. Funds use different state organizational vehicles, for example, corporations, business trusts, or limited partnerships. In addition, funds can be separate entities with a single class of shares, separate series of shares, or separate classes of shares. For an overview of different fund structures, see Sarah E. Cogan & Christopher P. Healey, *Fund Formation*, 1 MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATIONS, *supra* note 46, at 2-1.

73. 26 U.S.C. §§ 851–55 (2012). Other provisions outside of Subchapter M may also affect a fund's tax liability. *See e.g.*, *id.* § 4982 (imposing four percent excise tax on certain retained capital gains).

74. *See id.* §§ 701, 702(a), 1363(a), 1366(a) (stating, respectively, that partnerships are not subject to income tax; each partner must take into account his distributive share of the partnership's income; S corporations are generally not subject to tax; and each shareholder must take into account her pro rata share of the S corporation's items of income, loss, and deduction).

75. *Id.* § 702(a) (requiring each partner to take into account separately its distributive share of certain partnership items of income and loss); *id.* § 1366(a) (requiring a shareholder of S corporation to take into account its pro rata share of the corporation's items of income and loss).

company or UIT.[76] Moreover, the corporation must derive at least 90 percent of its gross income as passive income, i.e., dividends, interest, and gains from the sale of stock or securities, and satisfy certain diversification requirements with respect to its assets.[77]

To avoid entity-level tax, a RIC may deduct dividends paid to its shareholders from its investment company taxable income (ICTI).[78] Because ICTI is computed without regard to net capital gains,[79] a RIC is also permitted to deduct capital gains dividends against its net capital gains.[80]

To prevent a fund from accumulating income, a RIC is only eligible for the benefits of Subchapter M if it distributes at least 90 percent of the sum of its ICTI and tax-exempt interest income, computed without regard to the dividends paid deduction.[81] A RIC thus differs from a partnership and S corporation in that a RIC is nominally subject to tax to the extent that it does not distribute its net capital gains and ICTI. A RIC, therefore, might be described as a "tax centaur" in that, at times, corporate tax (separate entity) principles dominate and, at other times, pass-through principles dominate.[82]

Besides the avoidance of entity-level taxation, another fundamental characteristic of a pass-through regime is that the entity's income and losses maintain their same character when passed through to the entity's owners. Both Subchapters S and K specifically provide for such

76. *Id.* § 851(a)(1)(A). Common trust funds and business development companies can also be RICs. *Id.* § 851(a)(1)(B) (treating business development companies as RICs); *id.* § 851(a)(2) (treating certain common trust funds as RICs). A discussion of such entities is beyond the scope of this article. The terms fund and RIC are used interchangeably in this article.

77. *Id.* § 851(b)(2) (defining gross income test); *id.* § 851(b)(3) (defining diversification test); *see also* Prop. Treas. Reg. § 1.851-2(b)(1) (as amended in 1978), 81 Fed. Reg. 66,576 (Sept. 28, 2016) (modifying definition of gross income).

78. 26 U.S.C. § 852(b)(2) (2012) (defining investment company taxable income); *id.* § 852(b)(2)(D) (permitting a deduction against investment company taxable income for dividends paid to shareholders).

79. *See id.* § 852(b)(2)(A).

80. *Id.* § 852(b)(3)(A)–(B) (subjecting RIC to tax on the excess of net capital gains over the deduction for dividends paid determined with references to capital gain dividends).

81. *Id.* § 852(a)(1)(A)–(B). A RIC can retain its net capital gains, but the gains will bear corporate tax. *Id.* § 852(b)(1). A RIC can elect to require its shareholders to include in income the retained net capital gains, and shareholders will receive a credit for corporate taxes paid on the retained capital gains. *Id.* § 852(b)(3)(D)(i)–(ii). The shareholders are entitled to adjust the basis of their RIC shares by the amount of the retained gains less the corporate tax paid. *Id.* § 852(b)(3)(D)(iii).

82. RICs have been described as pseudo pass-through entities. *See generally* Donald E. Rocap & Russell S. Light, *The Mixed-Up World of Pseudo Passthroughs*, TAXES, Mar. 2007, at 323.

treatment.[83] Although Subchapter M does not contain the same explicit statutory mandate, a RIC's shareholders get look-through treatment for their share of the RIC's net capital gains, tax-exempt interest, and qualified dividends.[84] In addition, certain RICs can pass through foreign tax credits if they invest in foreign securities and earn mostly foreign source income.[85]

Subchapter M fails to implement a true pass-through regime for certain items of income and expenses. For instance, a RIC's short-term capital gains do not retain their character as short-term gains, and because they are included in ICTI, they are taxed as ordinary dividend income when distributed to a RIC's U.S. shareholders.[86] This is generally not beneficial to taxable individual shareholders because they cannot use the short-term gains to offset capital losses that are limited by § 1211.[87]

On the other hand, a RIC can net investment expenses against ICTI, whereas if the RIC were organized as a partnership or the shareholder directly incurred such expenses, such investment expenses would probably be subject to limitations at the owner level.[88] This rule is generally beneficial to taxable shareholders. Finally, losses are not passed through to fund shareholders; instead, the losses remain at the RIC level where they can be used to offset future gains.

Since a partnership's and S corporation's owners are taxed on their share of the entity's income, regardless of whether it is distributed, they

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83. *See* 26 U.S.C. § 702(b) (2012); *id.* § 1366(a).

84. Because capital losses can offset capital gains, the amount of short-term gains included in taxable income will equal the excess of short-term gains over short-term losses and long-term losses over long-term gains, if any. *Id.* § 1222(5) (defining short-term capital gain); *id.* § 1222(8) (defining net long-term capital loss); *see also id. id.* § 852(b)(3)(B) (treating capital gain dividend as LTCG); *id.* § 852(b)(5)(B) (treating exempt-interest dividend as tax-exempt interest under § 103); *id.* § 854(a) (defining capital gain dividend not treated as dividend); *id.* § 854(b)(1)(B) (qualified dividends).

85. *See id.* § 853(a)(1).

86. Short-term capital gains retain their character as capital gains when distributed to foreign shareholders. *See id.* § 871(k)(2)(D) (exempting foreign persons from tax on short-term capital gain dividends distributed by mutual fund). For a discussion of this and other related provisions, see Jeffrey M. Colon, *Foreign Investors in U.S. Mutual Funds: The Trouble with Treaties*, 35 VA. TAX REV. 483 (2016).

87. *See* 26 U.S.C. § 1211 (2012) (permitting capital losses to be used without limit against capital gains and any excess to be deducted against ordinary income up to $3,000).

88. *Id.* § 66(a)(1). These investment expenses also do not offset favorably taxed NCGs or qualified dividend income. *See* Rev. Rul. 2005-31, 2005-1 C.B. 1084. For individuals, the expenses would likely be deductible under § 212, but since these deductions are miscellaneous itemized deductions, an individual can deduct them only to the extent they exceed two percent of adjusted gross income. 26 U.S.C. § 67(a) (2012). In addition, the Treasury may not write regulations that prohibit the indirect deduction of these expenses for publicly offered RICs. *Id.* § 67(c).

must adjust the basis of their ownership interest.[89] Without the basis adjustment, upon the sale of the equity interest, the owner's gain or loss would duplicate the gain or loss already recognized.

Because a RIC is nominally taxed on its income and gains but avoids entity-level taxation by distributing its income or gains, the distributions are treated as dividends in the hands of shareholders, albeit with the character adjustments described above. Consequently, a shareholder is generally not permitted to adjust the basis of his shares for the income or gain received or not distributed.[90] Similarly, because a RIC cannot pass through losses to its shareholders, any expenses in excess of income and capital losses carryovers in the hands of the RIC remain at the RIC level.[91]

Subchapter M is a "tax centaur": it is an amalgamation of separate-entity and pass-through tax principles. Corporate tax concepts of Subchapter M include taxing RICs on their retained income and gains, taxing shareholders on contributions of property to a RIC,[92] treating RICs as corporations for mergers and acquisitions, and requiring RICs to maintain earnings and profits accounts for retained earnings (and gains). Pass-through tax principles applicable to RICs include unlimited deductions for payouts of income and gains and maintenance of character of most RIC distributions in the hands of shareholders. The treatment of a RIC's in-kind redemptions, however, is sui generis: unlike all other corporations, including S corporations, RICs are not subject to tax on the distributions of appreciated property, but unlike partnerships, RIC shareholders take a fair-market value (FMV) basis in the distributed property. Thus, the gain in the distributed property disappears. The regulation of in-kind redemptions and their tax treatment are discussed next.

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89. *See id.* § 705(a)(1) (requiring partner to increase basis by distributive share of partnership income); *id.* § 1367(a) (requiring S corporation shareholder to increase basis for income inclusion).

90. The election to attribute retained gains directly to an RIC's shareholders is one instance in which Subchapter M incorporates certain pass-through principles by allowing basis adjustment for retained gains. *Id.* § 852(b)(3)(D); *see supra* note 82.

91. Capital losses can be carried over indefinitely. *Id.* § 1212(a)(3)(A). Net operating losses cannot be carried over to reduce a RIC's investment taxable income in a subsequent year, but since they reduce NAV, they will reduce a shareholder's gain or increase loss upon a sale of the shares. *Id.* § 852(b)(2)(B).

92. *See, e.g.*, Syntax ETF Tr., Preliminary Prospectus (N-1A) (Jan. 18, 2017) (stating that an AP will recognize gain or loss upon the contribution of securities contributed to the ETF). This same fund states that it can reject contributions of securities if the transferor would not recognize gain or loss under § 351 because it was in control of the ETF immediately after the transfer. *Id.* at 49.

C. *In-kind Redemptions*

1. Regulatory and Accounting Rules

An open-end company is "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer."[93] The term "redeemable" security is defined as "any security . . . under the terms of which the holder . . . is entitled . . . to receive approximately *his proportionate share of the issuer's current net assets, or the cash equivalent thereof*."[94] In-kind redemptions of securities were clearly contemplated from the genesis of the federal regulation of mutual funds in the 1940 Act, although mutual funds almost always redeemed shareholders with cash.[95]

Prior to offering shares for sale, an open-end fund is required under both the 1933 Act and the 1940 Act to file a registration statement, which is subject to review and approval by the SEC.[96] The information that must be disclosed in the registration statement is found in Form N-1A and the accompanying instructions.[97] Parts A and B of Form N-1A detail the information required to be disclosed in the fund's prospectus[98] and the statement of additional information (SAI).[99] Part C describes the other information that the fund must supply to the SEC, including, inter alia, the articles of incorporation, by-laws, and instruments defining rights of security holders.[100]

Information on a shareholder's right to request redemption of its shares and the fund's right to satisfy the redemption request in cash or in

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93. 15 U.S.C. § 80a-5(a)(1) (2012).

94. *Id.* § 80a-2(a)(32) (emphasis added).

95. *See* Investment Company Liquidity Risk Management Programs, 81 Fed. Reg. 82,142, 82,145 n.24 (Nov. 18, 2016).

96. *See* 15 U.S.C. § 77(e) (2012) (prohibiting issuer to use the mails or other means of interstate commerce to sell securities unless registration statement is in effect); *id.* § 80a-7 (prohibiting a fund to engage in business unless registered under the 1940 Act). For a review of the registration process, see Michael Glazer, *Prospectus Disclosure and Delivery Requirements*, *in* 1 MUTUAL FUNDS AND EXCHANGE TRADED FUNDS REGULATION, *supra* note 46, at 4-1.

97. Closed-end funds must file form N-2. 17 C.F.R. § 239.14 (1978). Because closed-end funds do not offer shareholders the right to redeem their shares, they are not discussed in this Part.

98. A fund must deliver a "summary prospectus" to all purchasers of its shares and make available online a copy of its more detailed "statutory prospectus." *Id.* §§ 230–498(c) (2017).

99. *Id.* § 239.15A (requiring Form N-1A to be used for the registration of securities of open-end companies, i.e., mutual funds and ETFs, under the 1933 Act). Once the registration statement is approved, the fund must file with the SEC copies of the fund's prospectus and SAI. *Id.* § 230.497(c).

100. SEC, Form N-1A, item 28(a)–(c).

kind is found in these documents. Form N-1A, Item 11(c)(3) requires a fund to disclose whether in-kind redemptions are permitted,[101] and Item 11(e) must also describe relevant information relating to the frequent purchase and redemption of fund shares. A fund must also file as an attachment to its registration form the fund's articles of incorporation, charter, or declaration of trust.[102] The relevant formation document will describe the redemption rights of the fund's shareholders and the fund's right to redeem in kind. Also, the description of the capital stock of the fund must provide a fund discussion of, inter alia, the redemption provisions of each class of capital stock.[103]

To give flexibility to the fund manager, the offering document will generally reserve the right to pay shareholder redemption proceeds in kind.[104] After the SEC approves a fund's registration statement, the disclosures regarding shareholder and fund redemption rights can be found in both a fund's prospectus and SAI.[105]

Pursuant to Rule 18f-1, if an open-end fund has the right to make in-kind redemptions, it may elect to commit to pay in cash all requests for redemptions limited in amount for each shareholder for any 90-day period to the lesser of: (1) $250,000; or (2) one percent of the NAV of the fund at the beginning of the 90-day period.[106] Thus, a fund that issues redeemable shares possesses the right to redeem in kind, unless it

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101. *Id.* at item 11(c)(3) (requiring funds to disclose whether in-kind redemptions are permitted).

102. *Id.* at item 28(a). The particular instrument depends on whether the fund is organized pursuant to state corporate law or business trust law. For an overview of the various organizational forms, see Cogan & Healey, *supra* note 72, at 2-1.

103. SEC, Form N-1A, item 22(a)(2)(viii).

104. *See, e.g.*, Centerstone Inv'rs Tr., Amendment and Declaration of Trust (Form N-1A), exhibit 99.a, art. II, sec. 2(b) (Jan. 13, 2016):

> Payments for Shares so redeemed by the Trust shall be made in cash, except payment for such Shares may, at the option of the Board of Trustees, or such officer or officers as it may duly authorize in its complete discretion, be made in kind or partially in cash and partially in kind. In case of any payment in kind, the Board of Trustees, or its delegate, shall have absolute discretion as to what security or securities of the Trust shall be distributed in kind and the amount of the same.

Id. at 21.

105. *See, e.g.*, Fidelity Contrafund, Prospectus (Form 485BPOS) 17 (Feb. 26, 2016) ("Redemption proceeds may be paid in securities or other property rather than in cash if the Adviser determines it is in the best interests of a fund."); Fidelity Contrafund, Statement of Additional Information (Form 485APOS) 9 (Dec. 2, 2016) ("When possible, Fidelity will consider how to minimize these potential adverse effects [of large redemptions], and may take such actions as it deems appropriate to address potential adverse effects, including redemption of shares in-kind rather than in cash.").

106. 17 C.F.R. § 270.18f-1(a) (2017). The election, which is irrevocable, has to be disclosed in either the prospectus or statement of additional information. The election is filed on Form N-18F-1.

specifically elects not to reserve this right for certain redemptions. Form N-1A, Item 23(d) requires a fund to state whether it has received an order of exemption under § 18(f).[107]

Once a fund's registration statement has been approved by the SEC and it issues shares to the public, the fund is subject to a panoply of accounting and financial disclosure rules. Some of these rules are mandated by statute, e.g., the 1933 Act and the 1940 Act, and implemented by various SEC rules, e.g., Rule S-X, which prescribes rules for the presentation and content of financial disclosures.[108] In addition, funds must follow generally accepted accounting principles (GAAP) generally applicable to investment companies when disclosing their financial results.[109]

The registration documents discussed above detail a fund's right to redeem a shareholder in cash and in kind. The extent that a fund does so, however, is found in the fund's annual and semiannual financial reports.[110]

In its annual report, a fund must separately list its investments by the name of the issuer, the number of shares held, and the value of the investments and further group the investments by the type of investments, e.g., common stock, preferred stock, convertible preferred stock, and the related industry.[111] The investments in securities are listed on the balance sheet at their fair value, which is defined as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[112] The subtotal value of each type of investment is listed and the cost for financial reporting purposes is shown parenthetically for each subtotal as well as the percentage of net assets of a fund that each type of investment represents.[113] The total unrealized gain or loss in the investment assets equals the sum of the unrealized gains and losses in the securities broken out by type of investment.

107. SEC, Form N-1A, item 23(d) (requiring funds to state whether they have received an order of exemption under § 18(f)).

108. 17 C.F.R. § 210 (2017).

109. *See* FIN. ACCOUNTING STANDARDS BD., ASC TOPIC NO. 946-15-2, FINANCIAL SERVICES—INVESTMENT COMPANIES (2016). The GAAP guidance incorporates SEC-mandated accounting rules.

110. 15 U.S.C. § 80a-29(a) (2012) (requiring registered investment company to file annual report with the SEC); *id.* § 80a-29(e) (requiring registered investment company to send semiannual reports to shareholders); 17 C.F.R. § 270.30b1-1 (2017) (requiring registered investment companies to file a semiannual report on Form N-SAR).

111. 17 C.F.R. § 210.12-12(1)–(2) (2017). The regulations set forth other information that must be supplied. *Id.*

112. ASC TOPIC NO. 946, *supra* note 109, at 6.

113. 17 C.F.R. § 210.12-12(2) (2017). For each restricted security, the fund must list the acquisition date and acquisition cost. *Id.* § 210.12-12(8).

Following the fund's assets are the fund's liabilities, and the difference between the two is the fund's net assets. The net asset section details the sources of the total fair value of the assets less any fund liabilities. Net assets consist of paid-in capital and any undistributed net investment income or loss, which in turn, should be broken out into accumulated undistributed net investment income, accumulated undistributed net realized gains or losses on investment transactions, and net unrealized appreciation or depreciation in the value of investments at the balance sheet date.[114] The unrealized gain or loss in the net assets section may not be exactly equal to the unrealized gain or loss in the fund's investments because there can be included in net assets certain financial contracts, such as forward and futures, or foreign currency transactions that are not listed as investments.

A fund is required to state in a footnote its aggregate gross unrealized appreciation for all securities in which there is a built-in gain (BIG); the aggregate gross unrealized depreciation for which there is a built-in loss (BIL); the net BIG or BIL, and the aggregate costs for tax purposes.[115] These amounts are generally not exactly equal to the BIG or BIL listed in the balance sheet because of certain differences between tax and financial accounting in determining the cost basis of assets. For instance, temporary or permanent book-tax differences that arise from the application of the wash sales rules, the straddle rules, passive foreign investment company rules, and in-kind redemption rules can cause the book and tax cost basis and correlative gain or loss to diverge.[116]

The notes to the financial statements will disclose the gross amount of any in-kind redemptions, the total shares redeemed, and the net gain or loss realized on the in-kind redemptions. The following disclosure from the Fidelity Blue Chip Growth Fund is typical:

> Redemptions In-Kind. During the period, 1,878 shares of the Fund held by unaffiliated entities were redeemed for cash and investments with a value of $137,687. The net realized gain of $67,543 on investments delivered through in-kind redemptions is included in the accompanying Statement of Operations. The amount of in-kind redemptions is included in share transactions in the accompanying Statement of Changes in Net

114. *Id.* § 210.6-04(17).
115. *Id.* § 210.12-12(8).
116. *See, e.g.*, Fidelity Blue Chip Growth Fund, Annual Report (Form N-CSR) 35 (July 31, 2016) ("Book-tax differences are primarily due to foreign currency transactions, passive foreign investment companies (PFIC), redemptions in kind, partnerships, deferred trustees' compensation and losses deferred due to wash sales.").

> Assets as well as Note 10: Share Transactions. The Fund recognized no gain or loss for federal income tax purposes.[117]

When the securities are distributed, any unrealized gain or loss becomes realized for book purposes and is included as realized gain or loss in the Statement of Operations.

This information allows a reader to determine roughly whether the fund was distributing securities with greater or less realized gain or loss than the fund assets generally. For instance, the Fidelity Blue Chip fund owned at year-end securities worth $21,789,927,000 with a tax basis of $14,424,327,000.[118] The percentage of BIG in the distributed securities was 49.1 percent ($67.5 million/$137.7 million), whereas the percentage of BIG in the fund assets at year-end was 34 percent ($7.365 billion / $21.789 billion).[119]

2. Taxation of In-kind Redemptions

Throughout the history of U.S. investment companies, in-kind distributions have been exempt from tax at the fund level. As Congress began to limit and finally prohibit in 1986 the tax-free distribution of appreciated property by corporations, it continued to specifically exempt open-end funds from this rule. There is scant discussion in the legislative history for the justification for this exemption or why closed-end funds were not also eligible. Perhaps the simplest explanation for the legislative silence is that when § 852(b)(6) and its statutory predecessors were enacted, in-kind distributions from open-end funds were rare.[120] ETFs, for which in-kind redemptions are part of their genome, were only first offered in 1993, seven years after § 852(b)(6) was enacted.

Under current law, the tax consequences of a redeeming shareholder of a mutual fund are straightforward. In the case of a cash redemption, the redemption is treated as a sale or exchange under § 302(b)(5),[121] and a redeeming shareholder recognizes capital gain or loss determined by the

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117. *Id.* at 37. Because the numbers in the excerpt are in thousands, the unrealized gain in the distributed securities was approximately $67,543,000. *See id.*

118. *Id.* at 41.

119. This calculation is only approximate because it is not possible to know the BIG or BIL in the fund's assets when the in-kind distributions were made. Also, the disclosure does not separate the amount of cash that was distributed with the securities. *Id.* at 37.

120. In adopting Rule 18f-1, which permits a fund to elect to commit to make most redemptions in cash, the SEC stated that "redemptions in kind are extremely rare." Election by Open-End Investment Companies To Make Only Cash Redemptions, 36 Fed. Reg. 11,919 (June 23, 1971).

121. *See* Stephen D. Fisher, *RICs and the Retail Investor: A Marriage of Convenience or Necessity?*, 66 TAX LAW. 331, 371 (2013).

difference between the value of any cash over the shareholder's adjusted basis in the fund shares redeemed.[122]

Prior to the enactment of § 302(b)(5), it was possible that a redemption by a mutual fund could have been treated as a dividend if the shareholder did not completely redeem his or her shares. Generally, if a minority shareholder's interest in a corporation completely terminates or declines as a result of a redemption, the redemption will be treated as a sale or exchange.[123] If, however, a particular shareholder redeemed a portion of his or her shares, but a larger shareholder simultaneously redeemed a larger percentage of his or her shares, the smaller shareholder could end up owning a larger percentage of the fund at the end of the day, which would preclude redemption treatment as being essentially equivalent to a dividend.[124]

In case of an in-kind redemption by an ETF, the fund-level treatment is clear: under § 852(b)(6), the ETF does not recognize any gain or loss.[125] The shareholder level treatment, however, is not entirely clear.

Section 302(b)(5) was enacted in 2010 to provide a bright-line rule for redemptions from open-end funds because of the uncertainty of applying the redemption rules of § 302(b)(1)–(4) to funds that offered continuous redemption of shares.[126] Section 302(b)(5), which mandates sale or exchange treatment for redemptions, requires that the redeeming fund "issue[] *only* stock which is redeemable upon the demand of the stockholder."[127] Although all shares presented in an ETF creation unit are redeemable upon the demand of the AP (or another shareholder that has assembled one or more creation units), outside of the creation unit

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122. 26 U.S.C. § 1001(a)–(b) (2012).

123. Under *U.S. v. Davis*, for a redemption of stock to be treated as not essentially equivalent to a dividend, the redemption must result in a "meaningful reduction of the shareholder's proportionate interest in the corporation." U.S. v. Davis, 397 U.S. 307, 313, *reh'g denied*, 397 U.S. 1071 (1970). Generally, once a shareholder's interest declines below 50 percent, any reduction in voting power is treated as a sale or exchange. *See* Rev. Rul. 76-385, 1976-2 C.B. 92, at 5 (finding that reduction in a shareholder's ownership interest from 0.0001118 percent to 0.0001081 percent should be treated as meaningful).

124. *See* Rev. Rul. 81-289, 1981-2 C.B. 82 (holding that for a redemption not to be essentially equivalent to a dividend, a shareholder's voting interest, interest in the earnings through dividends, or interest in the assets of the corporation upon liquidation must decline). In this case, the shareholder's interest in all these items would increase.

125. If an ETF is an RIC and the securities are appreciated, § 852(b)(6) applies and no gain is recognized. If the distributed securities have a BIL, they are covered by § 311(a), and no loss is recognized.

126. JOINT COMM'N ON TAXATION, 111TH CONG., JCX-49-10, TECHNICAL EXPLANATION OF H.R. 4337, THE "REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010" FOR CONSIDERATION ON THE FLOOR OF THE HOUSE OF REPRESENTATIVES 20 (2010).

127. 26 U.S.C. § 302(b)(5)(B) (2012) (emphasis added).

redemption, ETF shares are not ordinarily redeemable upon the demand of a stockholder.[128]

It may be appropriate to interpret "redeemable upon the demand of the stockholder" in § 302(b)(5) as referring to shares of any open-end fund. This identical language is found in § 852(b)(6) and its statutory antecedent, former § 311(d)(1)(E). When those provisions were enacted, the language was meant to apply to open-end (mutual) funds as opposed to closed-end funds. Although ETFs did not exist when these provisions were enacted, because ETFs are open-end funds they arguably should be able to benefit from this provision.

If, however, that language is intended to track the definition of "redeemable security" under the 1940 Act,[129] there may be an issue as ETFs generally require an exemption from this definition in order to be publicly offered.[130] In an exemption application, the applicant typically acknowledges that there is a question whether shares of an ETF that are not individually redeemable satisfy the definition of "redeemable security" and consequently whether an ETF would be an open-end management company.[131] The SEC has proposed rules that would treat ETF shares as redeemable securities under § 2 of the 1940 Act, but they have not yet been finalized.[132]

Even if ETFs are not explicitly covered by § 302(b)(5), it is likely that most redemptions of creation units would be treated as sales or exchanges.[133] If an AP redeemed completely from an ETF, the redemption would be treated as a sale or exchange with the AP realizing gain or loss based on the difference between the AP's adjusted basis in the redeemed ETF shares and the value of the distributed securities and any cash.[134] In the case of a partial redemption, assuming that an AP owned less than 50 percent of a fund after it redeemed shares, the redemption should be treated

128. Section 302(b)(5) applies specifically to redemptions of stock of a publicly offered RIC; an ETF would certainly be considered publicly traded under § 67(c)(2)(B).

129. 15 U.S.C. § 80a-2(a)(32) (2012).

130. *See, e.g.*, N. Tr. Invs., Inc., Application for Exemption and Other Relief Filed Under the Investment Company Act of 1940 (40-APP/A) 41 (Aug. 22, 2011).

131. *See id.* ("Because Shares will not be individually redeemable, a possible question arises as to whether the definitional requirements of a 'redeemable security' or an 'open-end company' under the 1940 Act would be met if such Shares are viewed as non-redeemable securities.").

132. Under Prop. Treas. Reg. § 270.6c-11(a) (2008), ETF shares are considered "redeemable securities" for purposes of § 2(a)(32) of the 1940 Act.

133. This is the position of counsel to ETFs. *See, e.g.*, SPDR S&P 500 ETF Tr., *supra* note 63.

134. 26 U.S.C. § 302(b)(3) (2012).

as not essentially equivalent to a dividend as the AP's interest in the fund should decrease immediately after the redemption.[135]

Regardless of whether a redemption is treated as a sale or dividend, the AP will take a FMV in the distributed securities.[136] The shareholder's holding period of the securities received will not tack to the fund's holding period.[137] Apart from the shareholder treatment of an in-kind redemption, it is important to remember that the fund does not recognize gain or loss upon the in-kind distribution of securities.[138] Consequently, any BIG or BIL in the distributed shares disappears at the fund level.

3. In-kind Redemptions and the Disappearance of Fund BIGs

When a RIC distributes property in kind in redemption of a shareholder, the BIG or BIL in distributed securities disappears at no tax cost or benefit to the non-redeeming shareholders. Contrast this result with an actual sale of the securities and distribution of cash: if the sale generated gains, those gains would either increase the taxable income or net capital gains of all remaining shareholders; if the sale generated losses, those losses would reduce taxable income, net capital gains, or increase capital loss carryovers. For the redeeming shareholder, any relationship between the BIG or BIL of the distributed securities and the gain or loss recognized by the distributing shareholder is mere happenstance, because the fund manager decides which securities to distribute to the redeeming shareholder.

Because Subchapter M is a pass-through regime that is designed to eliminate entity-level taxation of gains, why should a fund have to recognize gain on the distribution of appreciated securities? The tax policy concern is that the tax-free distribution of appreciated securities exploits a structural weakness in Subchapter M, which is the failure to match taxable gains of a fund to the economic gains of the fund's shareholders. The distribution non-recognition rule permits non-redeeming shareholders who own appreciated shares to unjustifiably defer tax on their economic

135. *See supra* text accompanying notes 124–27. There are certain scenarios in which application of § 302(b)(1) is not clear. For example, assume that an AP redeems shares at 10:00 a.m. and reduces its interest in a fund from two percent to one percent, but two minutes later it purchases additional shares so that its interest in the fund increases to 2.5 percent. Is a momentary reduction in the ownership of a fund sufficient to ensure that the redemption was not essentially equivalent to a dividend? The application of the "not essentially equivalent to a dividend" standard to these types of transactions is not clear.

136. Treas. Reg. § 1.1012-1 (2010). If the distribution were not treated as a sale or exchange but instead as an ordinary distribution under § 301(a), the distributed securities would take an FMV basis. 26 U.S.C. § 301(d) (2012).

137. *See id.* § 1223(2).

138. *See id.* § 852(b)(6).

gains until they sell their shares, even though the securities of the fund that gave rise to those gains have been distributed *tax-free* from the fund.

The following example demonstrates this phenomenon. Assume that the ETF tracks the return of index *A* by holding a portfolio of the shares of index *A* (portfolio A_1, A_2, etc.), the shares of portfolio A_1 all increase or decrease by the same percentage, and an AP can create a single share of the ETF.

Example 1

> AP contributes portfolio A_1 with a value of $100 to an ETF in exchange for a share, which is sold to a retail shareholder for $100. Over the year, portfolio A_1 appreciates by $100 to $200. At the end of the year, AP contributes portfolio A_2 (basis = $200; FMV = $200) to ETF in exchange for a share with a NAV of $200. AP later requests to be redeemed, and the ETF distributes portfolio A_1, which has a basis of $100 and a FMV of $200, to AP in redemption of its share.

The ETF does not recognize gain on the distribution of portfolio A_1 under § 852(b)(6), and AP recognizes gain or loss based on the difference between the adjusted basis ("AB") of its ETF share ($200) and the FMV of portfolio A_1 ($200), or $0. This example also demonstrates that a redeeming shareholder's gain has no necessary relationship to the BIG in the distributed securities. Because the redeeming shareholder takes a FMV basis in the distributed property, the BIG in portfolio A_1 disappears at the fund level.

The retail shareholder, however, still owns his ETF share with a basis of $100 and a FMV of $200, but the $100 of economic gain that gave rise to the increased NAV is not matched by the taxable BIG at the fund level. In fact, in Example 1, after portfolio A_1 is distributed, there is no remaining BIG in the fund. Thus, even if the ETF immediately sold all its assets (in this case, portfolio A_2) for $200, it would not recognize any gains, and the retail shareholder would not have any taxable income. The retail shareholder will not recognize any gains until he disposes of his share.

This example clearly demonstrates the much-vaunted tax advantage of ETFs.[139] This advantage can be significant for fund shareholders. For example, in 2015, the 25 largest equity ETFs distributed securities with BIG of almost $60 billion.[140] For 2015, the total capital gains distributed by all equity funds was $331 billion.[141] These 25 equity ETFs, however, did not distribute any capital gains to their shareholders. The $60 billion

139. *See supra* text accompanying notes 5–6.

140. *See* Annex A. This is the gross BIG. Two funds distributed securities with net BIL. The data shown is for the funds' taxable years that began in 2015.

141. FACT BOOK, *supra* note 4, at 201 tbl.30.

of BIG in these distributed securities disappeared and will not be recognized until the fund shareholders dispose of their shares.

The fund manager has the discretion to select which securities to distribute in kind. If the goal is to reduce a fund's BIG and thereby minimize future capital gains distributions, the manager will likely choose to distribute low-basis (high BIG) shares.[142] In the 25 funds listed in Annex A, there was a total of $8 billion of BIL at year-end and a total of $60 billion of gross BIG distributed and only two funds distributed securities with a net BIL.[143] To reiterate, the gains in the distributed securities will not be taxed to any remaining shareholder until the current shareholders with BIG in their ETF shares sell their shares. If the shareholders do not sell their shares, the gain is indefinitely deferred.

The exemption from tax on the distribution of appreciated property is equivalent to treating the distribution as a taxable event to the fund but exempting the recognized gains from entity-level tax. The ability to eliminate fund-level capital gains by the tax-free distribution of appreciated securities permits non-redeeming shareholders to obtain an after-tax accumulation in their ETFs similar to the accumulation they would earn if the ETF were held in a nondeductible IRA account, in other words, no taxation until the shareholder withdraws from the account, in this case a sale of the ETF shares.[144] In fact, the ETF investment can potentially generate a higher return than a nondeductible IRA because the ETF shareholder will realize capital gains on the sale of the shares, whereas a distribution from a nondeductible IRA is ordinary income.[145]

Moreover, it is even possible that all of the unrealized gains of the distributed securities could have been short-term gains. Because the non-redeeming shareholders get the benefit of deferral, this allows them to turn

142. In Example 1, there was only one appreciated portfolio share basket, and it was assumed that all the shares of the basket appreciated or depreciated by the same percentage. More realistically, the ETF will own many baskets of shares, and each basket will have a different amount of depreciation or appreciation. For instance, the ETF could hold various shares of Apple stock and some shares could have appreciated in value and some depreciated since they were contributed to the ETF. When a fund gets a request to redeem from an AP to distribute a basket of securities including the Apple stock, the fund manager has the valuable option to pick the Apple shares that have the greatest BIG.

143. *See* Annex A.

144. For the rules for nondeductible contributions to IRAs, see 26 U.S.C. § 408(o)(2)(B)(i) (2012). Distributions from an IRA to which nondeductible contributions have been made are taxable as ordinary income to the extent that the distribution is not attributable to the nondeductible contribution, which is received tax-free. Nondeductible contributions are recovered in proportion to the ratio of nondeductible contributions held in all IRAs at the end of the calendar year to the total balance of all IRAs at the end of the calendar year. *See id.* § 408(d)(2)(C).

145. If an ETF pays out taxable income, for example, from dividends, however, the return in an after-tax IRA could be greater than the return from holding the ETF directly.

short-term gains at the ETF level into long-term gains at the shareholder level. This result is certainly not a conscious tax policy decision but has arisen because of the financial innovation of ETFs that relies on the exploitation of a tax rule that was not originally intended to apply to RICs except in rare circumstances.

D. *Turbo Charging the § 852(b)(6) Exemption Rule*

Market participants have developed new techniques that turbocharge the § 852(b)(6) exemption by extending it far beyond its original intent.[146] These techniques include creating a special ETF share class for mutual funds, buying and holding briefly mutual fund shares that will be redeemed with appreciated securities, and offering shares of a publicly traded mutual fund with the option to redeem in-kind creation shares.

Vanguard, the second largest asset manager with approximately $4 trillion of AUM,[147] offers 70 ETFs and is one of the most aggressive beneficiaries of § 852(b)(6). In 2015, Vanguard had 8 of the largest 25 equity ETFs, these funds distributed securities with BIG of $23.6 billion, and the Vanguard Total Stock Market Fund alone distributed securities with BIG of $11.7 billion.[148]

Unlike other ETFs, Vanguard's ETFs are a separate share class of a Vanguard index mutual fund, but with the normal limitations and benefits associated with typical ETFs, e.g., continuous trading at market price only on an exchange, and redemption rights only for APs.[149] When ETF shares are redeemed, the mutual fund can distribute appreciated securities without the recognition of gain under § 852(b)(6), which benefits not only the ETF shareholders but also the mutual fund shareholders.[150] On the other hand, this structure may be slightly less efficient than regular ETFs because cash redemptions by mutual fund shareholders could generate

146. These techniques have been noted by other commentators. *See* Sheppard, *supra* note 25, at 1240; Robert Gordon, *ETF's Secret Sauce*, TWENTY-FIRST SECURITIES CORPORATION 2, http://www.twenty-first.com/pdf/ETFs_Secret_Sauce.pdf.

147. Sarah Krouse, *Vanguard Reaches $4 Trillion for the First Time*, WALL ST. J. (Feb. 10, 2017, 6:40 PM), https://www.wsj.com/articles/vanguardreaches-4-trillion-for-first-time-1486745349.

148. For a complete list of Vanguard's ETFs, see *Vanguard ETF List*, ETFDB.COM, http://etfdb.com/issuer/vanguard/#etfs&sort_name=assets_under_management&sort_order=desc&page=3 (last visited July 15, 2017). For the BIG of the Vanguard funds, see Annex A.

149. For a description and overview of the Vanguard ETF shares, see Vanguard U.S. Stock ETFs Prospectus (Form N1-A, filed as 485BPOS) 67–68 (Apr. 27, 2016).

150. Vanguard explicitly touts this benefit. *Common ETF Questions*, VANGUARD, https://investor.vanguard.com/etf/faqs?lang=en (last visited Mar. 21, 2017) ("Vanguard ETFs can also use in-kind redemptions to remove stocks that have greatly increased in value (which trigger large capital gains) from their holdings.").

capital gains for ETF holders. Vanguard has obtained a patent for this structure,[151] which has forced other mutual fund families to devise other structures for turbocharging § 852(b)(6).[152]

Another strategy to turbocharge § 852(b)(6) is being employed by ReFlow Fund LLC, which provides liquidity to mutual funds experiencing net redemptions of their shares.[153] A fund that experiences net redemptions may be forced to sell securities to generate cash to pay redeeming shareholders. When a fund sells securities, it incurs trading costs, which are borne by the remaining shareholders, and the security sales may also generate taxable gains for the remaining shareholders.

A fund participating in the ReFlow program may draw down funds from ReFlow when the fund experiences net sales,[154] and the fund then uses the ReFlow capital to pay redeeming shareholders to minimize fund transaction costs, such as brokerage fees and taxable gains. Instead of structuring the transaction as a loan to the mutual fund, however, ReFlow advances capital to the fund by actually purchasing shares of the fund, which uses the proceeds to pay redeeming shareholders.[155] Thus, ReFlow's investment is not used to purchase securities in the fund.

The typical fund disclosure states that ReFlow will request redemption of its shares when the fund experiences net sales, at the end of a maximum holding period determined by ReFlow, which is generally one month, or at ReFlow's discretion.[156] Importantly, ReFlow may request redemption in kind, which permits the fund to distribute appreciated securities to satisfy the redemption request.[157] ReFlow specifically advertises this as being a benefit of participating in the ReFlow liquidity

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151. U.S. Patent No. 6,879,964 B2 (issued Apr. 12, 2005).

152. Ari I. Weinberg, *Firms Try Varied Designs to Add ETFs*, WALL ST. J. (Feb. 3, 2013, 4:47 PM), https://www.wsj.com/articles/SB10001424127887324624404578255940811549604 (describing master-feeder structure).

153. A fund's relationship with ReFlow can be found in the fund's prospectus and payments to ReFlow are sometimes disclosed in a fund's annual statement. *See, e.g.*, Eaton Vance Special Inv. Tr., Prospectus (Form N-1A) 91 (Mar. 1, 2017) (detailing the fund's participation in ReFlow Liquidity Program) [hereinafter Eaton N-1A].

154. *Id.* ("ReFlow provides participating mutual funds with a source of cash to meet net shareholder redemptions by standing ready each business day to purchase fund shares up to the value of the net shares redeemed by other shareholders that are to settle the next business day.").

155. ReFlow received a no-action letter from the SEC in 2002 regarding its program. ReFlow represented to the SEC that it requires a fund's board of directors to show that it approved of the fund's participation and specifically found that the fund's participation was in the best interest of the fund and its shareholders. *See* ReFlow Fund, LLC, SEC No-Action Letter, 2002 WL 1493234 (July 15, 2002).

156. Eaton N-1A, *supra* note 153, at 91.

157. *Id.*

program.[158] In exchange for providing the liquidity, ReFlow receives a fee that is determined under an auction process.[159]

The purported benefits to a fund of using ReFlow include: a reduction of a fund's trading costs that would be incurred to sell securities to satisfy redemption requests, cheaper cost of short-term borrowing, a reduction in the amount of cash a fund must hold to satisfy redemption requests, and the ability to distribute appreciated securities in satisfaction of ReFlow's redemption requests.[160]

The ReFlow shares function similarly to the creation shares of an ETF: they operate as a mechanism to distribute appreciated securities to ReFlow and thereby help a fund lower its potential future tax liabilities. Unlike an AP, however, which both contributes and receives securities, ReFlow only contributes cash that is never used to purchase securities but receives securities when it redeems. The ReFlow investment does not seem to aid in price discovery.

The newest variation on turbocharging § 852(b)(6) is the launch of NextShares by Eaton Vance, which are exchange-traded managed funds that combine various structural elements of mutual funds and ETFs.[161] Unlike most ETFs, which generally follow passive strategies, NextShares are shares of actively managed portfolios. Consequently, they do not disclose their current portfolio positions.

Like ETFs, retail shareholders purchase and sell NextShares on an exchange, but cannot request redemption of their shares from the underlying fund. Unlike ETFs, however, the price at which the shares will trade will be at the fund's next daily NAV plus or minus a market-

158. *See Redemption Service*, REFLOW, https://www.reflow.com/redemption-service.php (last visited July 15, 2017).

159. The fee is calculated based on a Dutch auction process, and, according to ReFlow, the minimum bid is 20 basis points. *See id.* For a description of the auction process, see Letter from Douglas J. Scheidt, Assoc. Dir. of the Div. of Inv. Mgmt., to the SEC 4–10 (July 12, 2002) (requesting no enforcement action for participation in the ReFlow Share Auction Program). The in-kind redemption feature was not discussed in the no-action letter request or SEC reply.

160. It appears that while it is a shareholder, ReFlow bears the risk of a drop in the value of its shares. To protect against a drop in the fund's NAV, ReFlow could hedge its exposure to fund price movements. For example, if ReFlow somehow knows the securities it will receive when it redeems its shares, it could short the securities when the investment is made and upon redemption of the fund shares, deliver the in-kind shares it received from the fund to close out the short sale. There may be other mechanisms for ReFlow to hedge its exposure.

161. Eaton Vance NextShares Tr., Prospectus (Form N-1A) amend. no. 5, 4–5 (Dec. 10, 2015). Eaton Vance received an exemption letter from the SEC to offer NextShares. *See* Investment Company Act of 1940 Release No. 31,361, 110 SEC Docket 2202, 2014 WL 6768923 (Dec. 2, 2014).

determined premium or discount that may vary during the trading day.[162] There is thus no opportunity to trade NextShares at intra-day prices. The premium or discount is determined by various market factors, including the supply and demand for shares, transaction costs, and the competition among market makers.[163] In contrast, the price at which ETF shares trade does not necessarily reflect NAV, but instead reflects the supply and demand for the ETF shares.

Like ETFs, only APs can create or redeem their NextShares directly with the fund,[164] and redemptions are primarily on an in-kind basis.[165] This feature permits the fund to use the redemption of the NextShares as a vehicle to distribute appreciated securities and thereby lower the mutual fund's future capital gains for its current and future shareholders.

Eaton Vance touts the ability to distribute appreciated securities through the in-kind redemption process and reduce future capital gains distributions as being a valuable characteristic of NextShares.[166] Since their launch only two years ago, at least 14 other investment managers have announced that they have entered into preliminary agreements with Eaton Vance to offer NextShares.[167]

These financial innovations by investment managers have turbocharged § 852(b)(6) far beyond its original intent and are being used to undermine the basic principles of Subchapter M by eliminating capital gains tax at the fund level. Shareholders in such funds are only taxed on income distributions and on the sale of their fund shares. This creates a wedge between the tax treatment of ETFs, the funds that use ReFlow, the funds that offer NextShares and regular mutual funds, offshore mutual funds, and other U.S. collective investment vehicles. Various options to eliminate this wedge are discussed below.[168]

E. The Divide between Inside and Outside Basis

One major structural weakness of Subchapter M is its failure to match the inside basis of a fund's assets with the outside basis of the fund's shareholders. Consequently, the BIG of the fund oftentimes has no relation

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162. Notice of Application for Exemption Order, Investment Company Act of 1940 Release No. 31,333, 110 SEC Docket 1013, 2014 WL 5768701, at *3 (Nov. 6, 2014). For example, for a trade executed during the day, the next daily NAV would be the NAV at the end of the day.

163. *Id.* at *3 n.10.

164. Eaton Vance NextShares Tr., *supra* note 161.

165. Notice of Application for Exemption Order, 2014 WL 5768701, at *3.

166. *See Introducing NextShares*, NEXTSHARES, www.nextshares.com/introducing.php (last visited Mar. 28, 2017).

167. *See id.*

168. *See infra* Part III.

to the BIG of the fund's shareholders. In Example 1, after the AP redeems its share, the total inside basis is $200 and the BIG is $0, but the total outside basis and shareholder BIG is $100. As demonstrated in Example 1, the ability to distribute tax-free appreciated property in redemption of a shareholder exacerbates the divide between inside and outside basis. The failure to match inside and outside basis also accounts for the possibility that new shareholders can be taxed on fund capital gains that arose before the shareholders entered the fund.

A shareholder purchases shares of a mutual fund at the fund's NAV.[169] For an ETF, the shareholder purchases shares at the market price, which presumably is close to the fund's NAV because of the creation and redemption activities of APs.[170] The purchase price establishes the shareholder's basis in his or her fund shares. The shareholder's basis in his or her shares (outside basis) may significantly diverge from the shareholder's proportionate interest of the fund's basis in its assets (inside basis) because the fund's assets may have appreciated or depreciated since the date the assets were purchased and the date the shareholder enters the fund.

Example 2

> A fund has one shareholder who owns one share of the fund with a basis of $50 and a FMV of $100, and the fund owns one share of Google with a basis of $50 and a FMV of $100. If a new shareholder purchases a share of the fund for $100, the fund's NAV, the new shareholder's basis in the fund share would be $100, but his or her share of inside basis, which is the sum of the basis of the Google share and cash, would be $75 (50 percent * $150).

If the fund sells the share of Google for $100 immediately after the new shareholder has entered the fund, the fund will realize gains of $50, and to avoid entity-level tax, it must distribute $25 to each shareholder.[171] The new shareholder, however, when he or she purchased the fund share for $100, economically paid for his or her share of the unrealized gain in the share of Google.

169. A fund may not offer to exchange its securities for anything other than its NAV without SEC approval. 15 U.S.C § 80a-11 (2012); 17 C.F.R. §270-22c-1(a) (2017) (requiring redemption or purchase price to be at the current NAV which is next computed after the redemption or purchase request).

170. *See supra* Part II.A.

171. In this example, it does not matter whether the capital gain is short-term or long-term, because it is the only income of the fund. For a taxable shareholder, however, whether the gain is short-term or long-term will matter.

In this example, even though the fund's assets did not appreciate since the new shareholder entered the fund, the new shareholder will be taxed on his or her share of the fund's existing BIG. The new shareholder is in essence taxed on his or her capital and not on the return on his or her capital. The fund's NAV will decline to $75 after it distributes the gain as a dividend, but the shareholder's basis remains at $100 because a shareholder is not permitted to reduce the basis of his or her shares when receiving a distribution of a capital gain dividend or a distribution of ICTI.[172] The tax surprises can arise even for shareholders who have long holding periods if the fund's economic gains arose prior to the purchase of their shares.

The fund shareholder only recoups this tax on this phantom income when the shareholder sells his or her shares. For instance, immediately after the dividend, the shareholder could redeem his or her shares for $75 and recognize a $25 loss to offset the $25 of phantom gain.[173] The sale, however, could trigger a redemption fee, and to avoid application of the wash sales rules, the shareholder would have to invest in another fund or wait more than 30 days to reinvest in the same fund.[174] Subchapter M could thus encourage shareholders to sell in order to avoid being temporarily overtaxed and not because they have changed their views of the mutual fund investment. The tax system surely should not encourage such behavior.[175]

A similar mismatch occurs when a shareholder purchases shares of a fund with a net BIL in its assets.

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172. 26 U.S.C. § 301(c)(1) (2012) (requiring distributions from corporations that constitute dividends to be included in income); *id.* § 301(c)(2) (requiring that distributions in excess of current and accumulated earnings and profits (E&P) reduce a shareholder's basis in his stock).

173. When the fund pays the dividend, its NAV will drop by the amount of the dividend.

174. *Id.* § 1091. For a discussion of the application of the wash sales rules to mutual funds, see Daniel W. Matthews, *Tax Loss Harvesting: Can Robo-Advisers Navigate Wash Sale Rule?*, TAX NOTES TODAY (Jan. 3, 2017).

175. This rule could be used affirmatively by shareholders. Assume that a shareholder has long-term capital losses (LTCLs) that he cannot use (or that will offset favorably taxed long-term capital gains (LTCGs). A shareholder could purchase a mutual fund that was going to make a distribution of NCGs and use the gains to eliminate the LTCLs. The losses now would be reflected in the shares of the mutual fund. The shareholder could then sell the shares of the fund and generate a short-term capital loss (STCL). Through this gambit, the shareholder would have succeeded in converting LTCLs into STCLs, which could be used to offset short-term capital gains (STCGs). To prevent this, § 852(b)(4) converts any STCL on the sale of a mutual fund held for six months or less into LTCL to the extent that a shareholder has received a capital gains dividend.

Example 3

> A fund has one shareholder who owns one share of the fund with a basis of $100 and a FMV of $50, and the fund owns one share of Google, with a basis of $100 and a FMV of $50. If a new shareholder purchases a share of the fund for $50, the fund's NAV, the new shareholder's basis in the fund share would be $50, but his or her share of inside basis would be $75 (50 percent * $150).

When the fund sells the share for $50, it will recognize a loss of $50. Although the fund cannot pass through the loss to shareholders, the loss can be carried forward and offset $50 of future gains. For instance, assume the fund purchases an asset for $50, and it subsequently appreciates to $100, at which time the fund sells it for a gain of $50. Because the fund can offset the $50 of gain with the $50 capital loss carryover (CLCO), the fund will not have any income to distribute, although its NAV will increase from $50 to $75.

In this case, the new shareholder has invested $50, the fund had an economic and tax gain of $50 since the investment ($25 of which is economically attributable to the new shareholder), but because the tax gain is offset by the realized BIL that existed prior to the investment by the shareholder, the shareholder will not pay tax on the economic gain until he sells his shares.[176] In this case, the mismatch between inside and outside basis inappropriately permits deferral of a fund's economic gain.

These tax phenomena are well known in the mutual fund tax and finance literature and the financial popular press. For nascent shareholders, the standard advice given in the financial popular press to avoid temporary double taxation is to forego investing in a fund prior to the fund's ex-dividend date if the fund is planning to make a substantial distribution.[177] The financial press has also noted that it can be beneficial to invest in funds with CLCOs because subsequently realized gains will not be taxed at the shareholder level until the CLCOs are extinguished.[178]

There are other self-help strategies available to shareholders to avoid being taxed on non-economic gains. For instance, a shareholder could redeem his shares before the record date. Mutual funds typically give

176. The same result occurs if the fund has an existing CLCO that can be used to offset future gains.

177. *See, e.g.*, Christine Benz, *Dos and Don'ts for Mutual Fund Capital Gains Season*, MORNINGSTAR (Sept. 24, 2015, 6:00 AM), http://news.morningstar.com/articlenet/article.aspx?id=715686.

178. *See, e.g.*, Carolyn T. Geer, *The Bright Side of Past Fund Losses*, WALL ST. J. (Apr. 4, 2011), http://goo.gl/SpVvXS. Because a fund can only use CLCOs against subsequently realized capital gains, a fund can generate ICTI and hence taxable dividends even though it has unused CLCOs.

estimates of a distribution a few months in advance of the dividend record date, so a shareholder will have some idea of the potential gains and income he or she will receive. If the distributions were going to be excessive or represented gains that were not reflected in his or her economic returns, a fund shareholder could redeem his or her shares prior to the record date.[179]

This strategy has its limits. A redemption would require a shareholder to recognize gain or loss on shares redeemed.[180] If the fund had economic gains since the shareholder had invested, the shareholder would be taxed on those gains, whether they were realized by the fund. This strategy seems only to make sense if the realized gains exceed the increase in NAV. That would suggest that the shareholder was being allocated pre-acquisition gains. As noted above, such sales could trigger a redemption fee, and any loss could be disallowed if the wash sales rules applied.[181]

This behavior also harms other shareholders because the redemption request may require the fund to sell securities to pay the redeeming shareholder. This selling could generate additional net capital gains (NCGs) that would be allocated to remaining shareholders and thereby potentially exacerbate the allocation of NCGs to shareholders who may not have benefited from them (or already paid for them when they purchased their shares).

A fund's taxable BIG or BIL in its assets is not easy to discover as it requires a deep dive into the footnotes of detailed financial filings.[182] The SEC did not address overhang (the amount of a fund's BIG) when it modified the rules requiring disclosures of after-tax returns in 2001.[183] Fund managers have historically paid attention to a fund's overhang because a significant amount of overhang dissuades investors from moving into the fund until the BIG is reduced.[184] Because fund managers

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179. The record date is generally one day before payment date. To avoid being a shareholder on the record date, the shareholder would have to request redemption of her shares on or before the record date to avoid the dividend. RICs can generally only distribute LTCGs once every 12 months. 15 U.S.C. § 80a-19(b) (2012); 17 C.F.R. § 270-19b-1(a) (2017).

180. Regardless of whether all or just a portion of the shares were redeemed, the redemption would be treated as a sale or exchange. 26 U.S.C. § 302(b)(5) (2012) (treating redemption of shares of a publicly traded RIC as a sale or exchange).

181. The wash sales rules would disallow any realized loss on the sold shares if the shareholder reinvested in the same fund within 30 days. *Id.* § 1091.

182. *See supra* Part II.C.1.

183. Disclosure of Mutual Fund After-Tax Returns, Exchange Act Release No. 33-7941, 74 SEC Docket 236 (Jan. 18, 2001).

184. *See* Michael Barclay, Neil D. Pearson & Michael S. Weisbach, *Open-End Mutual Funds and Capital-Gains Taxes*, 49 J. FIN. ECON. 3, 30, 33 (1998) (finding evidence that managers reduce overhang to attract new investors).

are generally compensated on the basis of AUM, a significant amount of BIG could be an impediment to investments by new taxable shareholders, which increases AUM, and thereby potentially lowers managers' compensation. Managers historically have therefore undertaken to reduce BIG.[185]

Fund annual reports contain information that lists a fund's tax BIG, usually in the notes to the financial statements.[186] In addition, independent mutual fund reporting services, such as Morningstar and Lipper, disclose a fund's BIG. Morningstar denominates this as "potential capital gains exposure" (PCGE). This figure can be negative if the fund has reported losses, which cannot be passed through to shareholders but which can be used to offset future taxable gains. As Morningstar points out, this figure is represented by a fraction of total capital gains divided by assets. Thus, if a fund's assets shrink because of redemptions, but the total BIG does not change, this fraction can significantly increase.[187] In theory, it could go to one.

Because Subchapter M adopts a modified entity-level tax regime, albeit with modifications to eliminate double taxation, it creates a divide between the inside basis of a fund's assets and the outside basis of the fund's shareholders. This division can lead to temporary double taxation of the same economic income and temporary double tax benefits from the same economic losses. The exemption from tax on the unrealized gains of securities distributed to redeeming shareholders further exacerbates the divide between inside and outside basis and permits the deferral of gain by non-redeeming shareholders and the conversion of short-term gains into long-term gains. This exemption has the effect of eliminating fund-level capital gains solely for ETFs and limiting ETF shareholder taxation solely to those shareholders who sell. There seems to be no articulated policy reason for this exemption.

III. FIXING THE IN-KIND REDEMPTION EXEMPTION

This Part considers various alternatives to the current rule that permits ETFs to make tax-free distributions of appreciated property. Some of the alternatives could be implemented within the current framework of Subchapter M, while others, drawing from the rules applicable to partnerships, would necessitate a substantial modification or possible repeal of Subchapter M.

185. *Id.*
186. *See supra* Part II.C.1.
187. *See generally Potential Capital Gain Exposure*, MORNINGSTAR (Jan. 25, 2005), admainnew.morningstar.com/directhelp/Methodology_PCGE.pdf.

The turbocharged use of § 852(b)(6) to eliminate fund-level gains permits non-redeeming shareholders to defer taxation until they dispose of their ETF shares. This result is largely equivalent to exempting the gains of ETFs from tax. Various commentators have advocated such an approach for all fund-level gains.[188] If that is a conscious policy decision by Congress, Subchapter M should be revised to explicitly extend this same result to all RICs, instead of solely permitting ETFs to benefit from the in-kind distribution exemption.

Exempting RICs from fund-level gains, however, would be a poor policy decision because it would encourage investors to move into RICs solely to avail themselves of the tax benefits. Moreover, the tax benefits could eventually end up being captured by fund families. Exempting fund-level gains from tax would move Subchapter M away from its original goal of establishing tax parity between direct investments in securities and investments in RICs.

The in-kind exemption for distribution of appreciated property from RICs is inconsistent with the original aim of Subchapter M, which was to provide smaller shareholders of RICs with roughly the same tax treatment had they held the RIC's securities directly. Section 852(b)(6), however, gives ETFs' shareholders a much better tax treatment than holding the shares directly. Section 852(b)(6) should just be repealed.

But even though there does not seem to be any clearly articulated tax policy for retaining the tax exemption for in-kind distributions, it is possible that taxing such redemptions could raise non-tax issues. There is a strongly held belief that the ability to make in-kind redemptions is an important relief valve for open-end funds. In-kind redemptions, the argument goes, could assist in dampening market volatility if mutual fund shareholders rushed en masse to redeem their shares for cash. As the Commissioner of the SEC recently stated: "Although in-kind redemptions are rarely made, the ability of an investment company to make redemptions in this manner is important because the sale of sizable blocks of securities to effect redemptions in cash would have the tendency to depress the market price of those securities."[189]

One could question whether the ability to distribute securities in kind would provide such a benefit. If a significant percentage of shareholders

188. *See* Brunson, *supra* note 25, at 160 (recommending that investors be able to exclude up to ten percent of their dividend income from mutual funds from the investors' taxable income); Coates, *supra* note 25, at 614 (discussing mutual fund reforms including the elimination of corporate capital gains); Travis, *supra* note 25, at 848–57 (arguing that fund shareholders should not be taxed on reinvested capital gains, but only when shares are sold or non-capital gain dividends received).

189. Piwowar, *supra* note 14.

redeemed and received securities instead of cash, one could posit that these same shareholders would rush to sell the securities received. Also, it seems reasonable to assume that these shareholders would be less skilled in selling the securities in an orderly fashion than a fund manager, and such unskilled selling could exacerbate volatility.[190] Thus, whether the fund or the fund's shareholders sell the securities should be irrelevant.

A related argument has been proffered by tax commentators to justify the tax exemption for in-kind distributions. They argue that taxing in-kind redemptions would undermine the in-kind relief valve of the 1940 Act because RICs could be forced to either make additional redemptions of property (potentially triggering the recognition of more gains) or distributions of cash raised by the sale of securities, which could also generate more gains.[191]

This argument too suffers from unquestioned assumptions. In the case of market distress, the price of the fund's securities will also drop and unrealized gains will tend to disappear. Similarly, if the redemption requests are triggered by poor fund performance, it is unlikely that the fund will have significant unrealized gains in its securities, and therefore the fund would not have to sell additional assets to generate cash to pay dividends to fund shareholders. Finally, if in-kind redemptions were taxable, the fund manager still would have the choice either to sell assets with no BIG or assets with BIL or the fund manager could distribute assets with a small amount of BIG—all actions which would mitigate any tax consequences to non-redeeming shareholders.

Another argument against repealing § 852(b)(6) focuses on the changing tax status of fund shareholders. Because tax-exempt retirement plans own an increasing share of RICs, the tax policy concerns raised by tax-free distributions may become less relevant.[192] At the end of 2015, IRAs and defined contributions plans (§§ 401(k) and 403(b)) owned 46 percent of total mutual fund assets.[193] There is no similar data for ETFs, although the percentage of ETFs currently held in retirement accounts is probably significantly less.[194] Institutional investors, such as pension funds

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190. Laura Sanders & Sarah Krouse, *Clients Pull Cash From Valeant Investor, Get Stock Instead*, WALL ST. J. (Apr. 8, 2016, 5:44 PM), https://www.wsj.com/articles/clients-pull-cash-from-valeant-investor-get-stock-instead-1460131047.

191. *See* JOHNSTON & BROWN, *supra* note 15, at ¶ 3.06[2][c]; Hodaszy, *supra* note 25, at 598.

192. For a discussion of the consequences of mixing taxable and tax-exempt shareholders in mutual funds, see Jeffrey M. Colon, *Oil and Water: Mixing Taxable and Tax-Exempt Shareholders in Mutual Funds*, 45 LOY. U. CHI. L.J. 773 (2014).

193. FACT BOOK, *supra* note 4, at 233–34 tbls.63 & 64.

194. Trang Ho, *The Debate Over ETFs in 401(k) Plans*, INSTITUTIONAL INV'R (Apr. 11, 2014), http://www.institutionalinvestor.com/Article/3330107/Asset-Management-

and sovereign wealth funds, which are tax exempt, own a significant and increasing percentage of ETF assets.[195] Because mutual funds currently do not raise the same issues regarding tax-free distributions as ETFs, however, the tax concerns for ETFs persist.

A. Imposing Limits on the Basis of Distributed Securities

An approach that could be applied within the current framework of Subchapter M is to tie the basis of the securities distributed in a redemption to the percentage of securities distributed. This is equivalent to limiting the BIG or BIL of the distributed securities to the percentage of securities distributed.

The IRS has issued private letter rulings to closed-end funds permitting them to distribute appreciated securities through in-kind tender offers without the recognition of gain under § 852(b)(6).[196] Because closed-end funds do not issue redeemable securities, they do not fall within the scope of § 852(b)(6), which requires that the distribution be "in redemption of its stock upon the demand of its shareholder."[197] The funds had applied for exemptive relief from the SEC to redeem their shares in order to reduce the discount to NAV in the fund shares, and some of the funds claimed that the in-kind redemptions were more beneficial than cash redemptions because cash redemptions would require the fund to sell illiquid assets that would "likely . . . yield depressed sales prices."[198]

The rulings justify applying § 852(b)(6) on the basis that the "policy concerns underlying § 852(b)(6) that are applicable to an open-end fund

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Indexing-and-ETFs/The-Debate-over-ETFs-in-401k-Plans.html#.WWoYAIqQy34 (stating that ETFs have been slow to catch on with retirement plans because of costs and lack of revenue sharing). This may change as large retirement plan providers begin to establish retirement plan platforms that incorporate ETFs as investment options. *See, e.g.*, Todd Shriber, *Schwab Debuts Low-Cost 401(k) ETF Program*, ETF TRENDS (Feb. 5, 2014, 12:53 PM), www.etftrends.com/2014/02/schwab-debuts-low-cost-401k-etf-program.

195. Andrew McCollum, *ETFs: "Active" Tools for Institutional Portfolios*, GREENWICH ASSOCS. 3 (Mar. 1, 2017), https://www.ishares.com/us/literature/brochure/2016-greenwich-research-associates-en-us.pdf (stating that a sample of institutional investors showed that 21 percent of their total assets were invested in ETFs in 2016 and 19 percent in 2015).

196. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2005-09-013 (Nov. 17, 2004) (permitting distributions of appreciated securities to redeeming shareholders from closed-end funds).

197. The rulings typically note that § 852(b)(6) does not define the term "redemption upon demand," but recognize that the better interpretation is that § 852(b)(6) is intended to cover open-end RICs based on legislative history to § 162(k)(2)(B). *Id.*; *see* H.R. REP. NO. 99-841, at II-168 (1986). Under § 162(k)(2)(B), mutual funds are exempted from the rule that prohibits a corporation from deducting any expenses related to the reacquisition of its stock.

198. I.R.S. Priv. Ltr. Rul. 2001-480-030 (Aug. 28, 2001).

are therefore also applicable to [the fund requesting relief]."[199] The noted policy concerns are that the fund "would be exposed to the market risk of disadvantageous sale price and to the risk of potential depletion of its holdings if it were required to sell assets to the meet the redemption requests."[200]

This rationale is not too convincing, because the holdings of a fund are equally depleted if cash is distributed. An in-kind redemption merely shifts selling costs from the fund to the shareholder. As discussed above, mutual funds very rarely distribute securities in kind and thus must obtain the cash to satisfy redemption requests from a sale of securities, cash reserves, or borrowed funds.[201] The unarticulated rationale may have been that if distributions were taxable, the fund would have to sell other securities to distribute to shareholders as a dividend to avoid entity-level taxation. Those dividends would deplete the fund's assets, and unlike mutual funds, closed-end funds do not have a simple mechanism to raise additional assets.

The IRS made a policy decision to extend § 852(b)(6) to any RIC, albeit with certain limitations that are not applicable to open-end fund redemptions, including ETFs. The IRS imposed on ruling applicants the requirement that the funds distribute a pro rata share of each of its securities where the ratio of the aggregate tax basis of the distributed securities to the total aggregate tax basis of the RIC's securities prior to redemption is approximately equal to the percentage of the RIC's securities being distributed.[202] This requirement ensures that a redeeming shareholder take securities with BIG or BIL proportionate to his or her shareholdings.[203]

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199. I.R.S. Priv. Ltr. Rul. 2005-09-013 (Nov. 17, 2004).

200. *Id.*

201. *See supra* Part II.C.

202. *See* I.R.S. Priv. Ltr. Rul. 2005-09-013 (Nov. 17, 2004). The IRS private letter ruling states:

> [S]ecurities distributed will have an aggregate tax basis that, as a percentage of the Fund's aggregate tax basis in all its assets prior to the redemption, is no more than one percentage point lower than the percentage of the Fund's aggregate tax basis in all its assets prior to the redemption, is no more than 1 percentage point lower than the percentage of the assets that are being distributed by the Fund.

Id. There are certain exceptions for restricted and unregistered securities. Some of the rulings state that following this approach, a redemption will "neither defer the recognition of gain to Fund's nonredeeming shareholders nor permit the disproportionate deferral of tax at Fund's level." I.R.S. Priv. Ltr. Rul. 2004-14-043 (Apr. 2, 2004).

203. Another way to see how this restriction caps the total unrealized gain that can be distributed is to note that inside a fund, NAV – Basis = BIG (BIL). If X percent of the NAV is being distributed and X percent of the basis is being distributed, then X percent of the BIG (BIL) is also being distributed.

Applying this approach to Example 1 above, because 50 percent of the assets are distributed ($200/$400) to AP, the fund could distribute securities with a basis of $150, which is equal to 50 percent of the total aggregate tax basis of the ETF's securities—the sum of $100 of the basis of portfolio A_1 and $200 basis of A_2 contributed to the ETF. After the distribution of $200 of securities with a basis of $150, the fund owns securities with a basis of $150 and a value of $200.

Although this approach reduces the BIG that can be removed tax-free from a fund, it still fails to tax all the appreciation in a fund's securities to the shareholder who has economically benefited from it. Note that if the fund sold the remaining securities for $200, it would have $50 of gain, which would be allocated and presumably distributed to the retail shareholder. Because the fund would now hold cash of $150, there would be no further gain at the fund level to be taxed to the retail shareholder. The shareholder's basis in his fund shares, however, remains $100, and the shareholder will be taxed on the remaining gain only when he sells his shares.

More importantly, each time a shareholder is redeemed, he or she removes a percentage of BIG tax-free from a fund equal to his or her ownership interest in the fund and regardless of the BIG in his or her shares. The percentage of BIG that can be removed is directly proportional to the total percentage of shares that are redeemed. In the case of an ETF, which continually issues and redeems shares, the continual redemption of shareholders permits a growing percentage of BIG to be removed.

A related approach would limit the BIG a manager could distribute to the BIG a redeeming shareholder has in its shares. Returning to Example 1, the fund manager in this case would be required to distribute to AP securities with a BIG of $0 and a basis of $200, which is the AP's basis in its ETF share. The ETF would retain securities with a basis of $100 and a value of $200, leaving the $100 of gain for the retail shareholder. Even if this proposal were limited to APs, it is not clear how the fund would know an AP's basis in the shares presented for redemption unless the AP disclosed that information to the manager.

This approach mitigates to some extent the problem of BIG stripping by APs, but it still does not resolve the failure of Subchapter M to match inside and outside basis for non-redeeming shareholders. For instance, if the retail shareholder sold its shares to a new retail shareholder for $200, the ETF's inside basis would remain at $100 and the NAV at $200, but that economic gain was recognized by the selling retail shareholder. Again, if the ETF sold the securities of A_1, the new retail shareholder would be taxed on the $100 of gain. Requiring further recognition of gain when those securities are sold results in temporary double taxation for the new retail shareholder.

B. *Repealing § 852(b)(6)*

An obvious solution to the problem highlighted above is to simply repeal § 852(b)(6) and subject all distributions of appreciated property to § 311(b). Because Subchapter M, following corporate tax principles, generally does not attempt to match inside and outside basis or to allocate gains and losses at the fund level to the shareholders who have economically benefited from or borne the burden of such gains or losses when appreciated assets leave the fund, gain or loss should be recognized when assets are distributed.[204]

As shown in Example 1 above, the current regime permitting tax-free distributions under § 852(b)(6) inappropriately removes and eliminates fund-level gains. Although gains are preserved at the shareholder level, § 852(b)(6) permits the removal tax-free of the fund-level gains that gave rise to the appreciation and thus allows shareholders to defer shareholder-level gain until they dispose of their shares.[205]

If § 852(b)(6) were repealed, some of the tax benefits of investing in ETFs would certainly diminish. Each time an ETF distributed appreciated securities, taxable gains would be generated for all remaining shareholders. One of the touted tax benefits of ETFs is the de-linkage between the tax consequences to redeeming shareholders and remaining shareholders. When a mutual fund sells securities to generate cash to pay redeeming shareholders, such sales can create taxable gains for non-redeeming shareholders. In contrast, when an ETF makes an in-kind distribution, only the redeeming shareholder recognizes taxable gains or losses, although the taxable gain on any ETF-level BIG in the distributed securities is eliminated.

This change should not be the death knell of ETFs because the ETF manager still retains the option to choose the securities to be distributed.[206] This is not unlike the decision a mutual fund manager must make when deciding what securities to sell to fund redemption requests. For instance, when the market is rising, the manager could follow a last in, first out (LIFO) scheme and distribute high-basis securities to redeeming APs and thereby minimize fund-level gains caused by redemptions. If, however, an ETF's securities were increasing in value, this could cause the ETF's

204. *See supra* Part II.E.
205. *See supra* Part II.C.3.
206. *See supra* Part II.C.3.

overhang to increase,[207] but again, this is the same choice a mutual fund manager must make. If the market was falling, the manager could distribute low-basis securities to redeeming shareholders to maximize an ETF's BIL.[208]

The tremendous growth of ETFs demonstrates that they are a major financial innovation, but this growth has certainly been stimulated by the favorable tax treatment of in-kind distributions. Tax has also played a major impetus in the creation of many other important financial products, such as zero-coupon bonds and trust preferred structures. When the tax subsidy was eliminated, the demand for products that are socially valuable, such as zero-coupon bonds and Eurobonds, has remained and even grown.[209] Since ETFs offer low management fees, exposure to a broad variety of indices, and instant liquidity at NAV or near NAV, there will be continued demand for these benefits so long as the value of these benefits exceeds the loss of the tax subsidy. Even if ETFs were to become tax disadvantaged but still offer economic benefits that mutual funds do not, ETFs may morph into investment vehicles that are best held by tax-exempt entities, such as pensions, sovereign funds, IRAs, and 401(k) plans. There is some indication that institutional investors are becoming a very significant class of ETF shareholders.[210] If, however, ETFs cannot survive without the tax subsidy, then that is an indication that they may not be socially beneficial.

C. *Reducing the Basis of Fund Property by Unrecognized Gain*

Another recently advocated approach[211] is to maintain the current non-recognition rule for distributions of appreciated property but to

207. For example, if a fund has three portfolios with bases of $100, $200, and $400 and each with a FV of $400, the BIG is $500. If the manager distributes the portfolio with a basis of $400, the BIG is still $500, but it now represents 62.5 percent of the FV of the fund's assets compared to 41.7 percent before redemption.

208. For example, if a fund has three portfolios with bases of $100, $200, and $400 and each with a FV of $100, the BIL is $400. If the manager distributes the portfolio with a basis of $100, the BIL is still $400 for the remaining shareholders, but now it represents 200 percent of the FV of the fund's assets compared to 133 percent before.

209. According to one prominent financial economist, "[t]he major impulses to successful financial innovations over the past twenty years have come, I am saddened to have to say, from the regulations and taxes." Merton H. Miller, *Financial Innovation: The Last Twenty Years and the Next*, 21 J. FIN. & QUANTITATIVE ANALYSIS 459, 460 (1986). He also describes how uneconomic tax rules created a demand for zero-coupon bonds, but noted that after the tax rules were changed, there was still demand for zero-coupon bonds because they eliminated reinvestment risk. *See id.* at 463.

210. *See* McCollum, *supra* note 195, at 3 (stating that institutional investors hold greater than 20 percent of their assets in ETFs).

211. *See* Hodaszy, *supra* note 25, at 600–01.

require a distributing fund to reduce the basis of its remaining property by any unrecognized gain of the distributed property. This approach specifically draws on § 362(c), which applies to contributions to capital of property and cash to a corporation when the contribution is not contributed as a shareholder in its capacity as a shareholder.[212] Under § 362(c), a corporation must generally take a zero basis in such property and reduce the basis of any property acquired with the contributed cash.[213] If there is cash remaining after one year, the corporation must reduce the basis of its other property.[214]

Unlike current § 852(b)(6), where the unrealized gain in the distributed property simply disappears forever at the fund level, the basis reduction proposal ensures that unrecognized gain in distributed property would be maintained at the fund level through the mechanism of the reduced basis in the fund's remaining securities. Thus, the unrealized gain does not disappear but instead is deferred at the fund level until the remaining securities are sold.

This proposal, the author suggests, is superior to an outright repeal of § 852(b)(6) because it would not interfere with the AP redemption process by potentially triggering current taxable gain when appreciated securities are distributed and it preserves at the fund level any unrecognized gain on the distributed securities.[215] Although the basis reduction proposal would certainly accomplish these goals, it should be rejected because it is inconsistent with sound tax policy principles and does not eliminate either the tax competitive advantages of ETFs or the current deficiencies of Subchapter M that fail to match taxable fund gains and shareholder level gains.

Although the basis reduction proposal preserves fund-level gain, there does not seem to be a justifiable tax policy reason to defer the gains when the appreciated assets leave corporate solution. The author offers as a policy justification for § 852(b)(6) the possibility of asset depletion in the case of "extreme market downturn."[216] As discussed above, this concern may be highly exaggerated.[217]

Furthermore, the author does not proffer a sound policy reason to treat for tax purposes the distribution of appreciated assets differently than

212. *See id.* at 600–02.
213. *See* 26 U.S.C. § 362(c) (2012) (amended 2014).
214. *See id.* § 362(c)(2) (amended 2014). The Treasury Regulations detail how the basis reductions are made to various categories of property. *See* Treas. Reg. § 1.362-2(b) (1960). Within each category of property, the reduction is done based on the adjusted basis of each property. *Id.*
215. *See* Hodaszy, *supra* note 25, at 605.
216. *See id.* at 575, 594.
217. *See supra* Part III.B.

the sale of appreciated assets followed by the distribution of cash. He claims that requiring gain to be recognized on the distribution of appreciated property would make it impossible for ETFs to continue.[218] Although elimination of § 852(b)(6) would certainly lessen the tax efficiency of ETFs, it is not certain that it would kill ETFs.

As discussed above, ETFs could mitigate any gain recognition caused by the distribution of appreciated property by distributing high basis property.[219] Even if ETFs became less tax efficient than similar mutual funds, the tax detriment could be outweighed by the ability to trade at intra-day prices and gain economic exposure to a variety of asset classes. Finally, if § 852(b)(6) were repealed, the natural tax clienteles would be tax-exempt entities, such as pension funds and IRAs, which certainly administer sufficient assets to support the continuing viability of ETFs. If ETFs are only viable because of the tax subsidy of § 852(b)(6), they should not survive.[220]

The proposal appears to ignore basis adjustments that exceed the adjusted basis of a corporation's property. Following the approach of the regulations under § 362, the basis reduction proposal reduces basis in proportion to the basis of the assets, but not in excess of zero.[221] In an example to illustrate the function of the proposal, there is insufficient basis to absorb the basis reduction, and the excess basis is apparently disregarded, which means that the gain is never recognized at the fund level.[222] Because the basis reduction proposal is designed to be a deferral mechanism and not an exclusion mechanism, a fund should have to recognize gain when the basis of the property is reduced below zero or apply the excess basis reduction to the basis of any remaining property.[223]

As noted by the author, ETFs currently rarely sell assets, except in the case of mergers or changes in the index the ETF is tracking.[224] Although this may change if the AUM of actively managed ETFs grows, for the foreseeable future the deferral of unrecognized gains by ETFs is tantamount to forgiveness. Also, the proposal does not address the tax

218. *See* Hodaszy, *supra* note 25, at 587, 595.

219. *See supra* Part III.B.

220. At least one commentator has questioned whether ETFs aid in price discovery other than between the price of ETF shares and the value of the underlying ETF portfolio. *See* Sheppard, *supra* note 25, at 1240 (questioning whether ETFs play a role in price discovery but concluding that they are a tax shelter).

221. *See* Treas. Reg. § 1.362-2(b) (1960).

222. *See* Hodaszy, *supra* note 25, at 604 n.296.

223. A shareholder must recognize gain when it receives a distribution that exceeds the corporation's current and accumulated E&P and the adjusted basis of the stock. 26 U.S.C. § 301(c)(3) (2012).

224. *See* Hodaszy, *supra* note 25, at 603.

consequences of complete liquidations: if deferred gain is not required to be recognized when an ETF liquidates, the manager could simply liquidate the fund and the fund-level gains would be entirely forgiven.

This proposal not only permits the inappropriate deferral of unrecognized gains when appreciated assets are distributed, it also exacerbates the problem of matching the taxable gains of a RIC to the shareholders who have economically benefited from those gains. Because ETFs currently rarely sell assets, the deferred gains could accumulate for years, and when they are eventually realized, it is unlikely that they would be allocated to the shareholders that economically earned them.[225]

Finally, this proposal may affect the trading of ETF shares because of the existence of the deferred tax liability. As the deferred gains in an ETF grow, retail investors may begin to discount the value of the ETF shares to reflect the possibility that the deferred taxes may be realized. To illustrate, assume that the NAV of an ETF is $20, but due solely to basis reductions, there is $10 of BIG per share. If retail shareholders believe that the $10 of BIG will be realized, they will discount the price of the shares, say to $18, which is $2 less than NAV.

Normally, in this case, APs could purchase shares at $18, redeem them with the ETF, and get back securities worth $20, and thereby make a riskless profit of $2. If, however, an AP wished to create and sell shares, it would have to contribute securities worth $20, but it could only sell them to retail shareholders for $18. To the extent that the purchases by the APs did not drive the price to $20, there would be purchases and redemptions of ETF shares but no creation of new shares. This scenario may be unlikely, however, as it would create an opportunity for tax-exempt investors because they could purchase and hold the shares without incurring any tax liability.

D. *Carryover Basis Regime*

Another approach that draws on other pass-through regimes such as partnerships and trusts is to require the recipient shareholder to take a carryover basis in the securities received.[226] A significant drawback to such an approach is that it would require some mechanism to prevent double taxation of the same gain. For instance, if a shareholder redeemed and recognized gain on the redemption and received shares with BIG, in a carryover regime, the sale of the appreciated property would also generate taxable gain and thereby turn Subchapter M into a double tax regime.

225. *See id.*
226. *See infra* Part III.E.7.

Special rules would also be needed to prevent the doubling of losses when depreciated property was distributed.[227]

A solution to prevent double taxation would be to treat in-kind redemptions as non-taxable, which is how distributions by partnerships to partners are treated.[228] This result is possible because partnership taxation treats partnership interests as having a unitary basis, requires a partner to reduce its basis in its partnership interest when the partnership distributes property, and generally endeavors to match inside and outside basis.[229] Mixing elements from the separate-entity treatment of Subchapter M, where there is no attempt to match inside and outside basis, and the aggregate treatment that generally applies in Subchapter K is unwise. Instead, serious consideration should be given to requiring ETFs to be subject to Subchapter K.

E. Partnership Tax Model for ETFs

Rather than repeal § 852(b)(6), Congress could prohibit ETFs and perhaps all RICs that offer creation-type shares from being subject to Subchapter M and instead require them to be subject to certain partnership tax rules. Basic principles of Subchapter K applied to ETFs could eliminate many of the current deficiencies of Subchapter M, albeit with a concomitant, very significant increase in administrative complexity.

Other commentators who have explored the infirmities of Subchapter M have suggested that the partnership tax model may be superior to Subchapter M,[230] but have generally dismissed applying partnership tax rules to investment companies. One commentator, while noting the benefits of Subchapter K, argued that the additional complexity of Subchapter K would outweigh the benefits of matching taxable and economic income.[231] None of these commentators, however, focused on the emerging tax policy challenges raised by ETFs.

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227. Under prior law, when property was distributed to a corporation as an ordinary distribution under § 301, it would take a basis equal to the lesser of its FMV or its adjusted basis. Treas. Reg. § 1.301-1(h)(2)(ii) (1960). This rule ensured that any BIG would be taxed to the corporate recipient, but that losses would not. Even though the regulation has not been withdrawn, it is overruled by § 301(d), which requires that all shareholders take a FMV basis of property distributed as a dividend. *See* 26 U.S.C. § 301(d).

228. *Id.* § 731(a)(1)–(2) (stating that no gain or loss is recognized by a partner receiving only capital gain property from a partnership).

229. *See infra* Parts III.E.4, III.E.7.

230. *See* Fisher, *supra* note 121, at 388 ("[I]t is the confluence of the Code and 1940 Act that prevents the use of the most logical alternative structure to RICs, the partnership.").

231. *See* Coates, *supra* note 25, at 614. The same commentator also stated, without much evidence, that "the complexity and costs associated with simply extending these [partnership tax] options to mutual funds would likely be cost-prohibitive in the standard,

The concerns about administrative complexity may be overblown, especially given that the complexity, at the fund level, is mostly one of computational record-keeping capacity, which current hardware and software may be capable of handling. At the owner-level, the reporting would be slightly different—investors would receive Form K-1 instead of Form 1099. Although the information supplied would be largely the same, Form K-1 can be more complicated for the average investor than Form 1099. In addition, since ETFs and mutual funds generally share economic gains and losses in proportion to their capital interests, some of the administrative complexity that is associated with special allocations by some partnerships disappears. Hedge funds[232] that invest primarily in securities generally follow some, but not all, of the rules discussed below, and publicly traded partnerships and ETFs that are taxed as partnerships follow many of the rules discussed below, although with some simplifying modifications to accommodate the administrative strains that arise when there is a significant turnover of ownership interests.[233]

1. The Current Prohibition of the Partnership Option for ETFs

Publicly offered investment companies are currently not eligible to elect partnership tax treatment. Under § 7704, a publicly traded partnership is generally treated as a corporation for tax purposes.[234] If, however, 90 percent or more of a partnership's gross income is "qualifying income," which includes interest, dividends, and gains from the sale of capital assets, the partnership will not be treated as a corporation.[235] Although most ETFs and mutual funds would satisfy the qualifying income exception, this exception is not available if the partnership would

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widely held mutual funds through which middle class investors typically invest." *Id.* at 606 n.23.

232. Generally, only accredited investors can invest in hedge funds. Thus, any complications arising from receiving a Form K-1 are handled by their tax preparers and not the investors.

233. *See, e.g.*, Direxion Shares ETF Tr. II, Registration Statement (Form S-1) 46–58 (Dec. 14, 2016) (describing the tax status of funds as partnerships and the consequences to U.S. shareholders).

234. 26 U.S.C. § 7704(a) (2012). Interests are publicly traded if they are either traded on an established market or on a secondary market or its substantial equivalent. *Id.* § 7704(b). ETF interests are clearly publicly traded, and even though mutual fund shares are not traded on an exchange, they would be publicly traded because the fund stands ready to redeem the shares at NAV. Treas. Reg. § 1.7704-1(c)(2)(iii) (1995). There are certain exemptions, for example, for private placements and certain redemptions, but they are inapplicable to publicly traded ETFs and mutual funds.

235. *See* 26 U.S.C. § 7704(c)(2), (d)(1)(A)–(B), (D). Qualifying income also includes income listed under § 851(b)(2)(A), such as gains from the sale of foreign currencies, options, forwards, and futures on securities. *Id.* § 7704(d)(4).

be a RIC if it were a U.S. corporation.[236] Because a publicly offered ETF or a mutual fund that invests primarily in securities would be a management company if it were a U.S. corporation, such entities cannot elect to be taxed as partnerships and get pass-through tax treatment only through the route of Subchapter M.

A partnership whose principal activity is buying and selling non-inventory commodities or forwards, futures, or options with respect to commodities can elect partnership taxation even if it would otherwise be a RIC.[237] Although the statute appears to require enabling regulations, some market participants have taken the position that it is self-enabling.[238] In addition, there is a significant number of publicly traded partnerships, referred to as Master Limited Partnerships (MLPs), which are actively engaged primarily in the oil and gas business.[239] Since they are not investment companies under the 1940 Act, they can be taxed as partnerships.

The existence of a significant number of MLPs, including ETFs, demonstrates that partnership taxation and publicly traded ownership interests can coexist. In addition, hedge funds are generally organized as partnerships for tax purposes and have thrived, although they are generally available only to accredited investors. Hedge funds, because they generally buy and sell securities, are more like ETFs than many MLPs, which are often operating companies.

2. Subchapter K

Subchapter K has a panoply of provisions that are designed to allocate the taxable gains and losses of a partnership to those partners who have economically benefited or suffered from the gains or losses. These provisions reflect an aggregate view of partnership taxation in which each partner is treated as owning an undivided interest in the partnership's assets. Some corollaries of the aggregate approach that incorporate fundamental tax principles are that a partner should not be able to use a

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236. *Id.* § 7704(c)(3).

237. *Id.* Currently 35 out of 1,983 ETFs are commodity ETFs taxed as partnerships. *See ETF Screener*, ETF DATABASE, etfdb.com/screener/#assetClass=Commodity&tax-form=K-1 (last visited Aug. 4, 2017).

238. *See, e.g.*, Pebble U.S. Mkt. Fund, L.L.C., Amendment No. 6 To Form S-1 Registration Statement (Form S-1) 22 (May 28, 2010) (stating that "the lack of regulations should not alter the Fund's classification as a partnership for tax purposes").

239. Under § 7704(d)(1)(E), qualifying income includes income from the "exploration, development, mining or production" of any natural resource. 26 U.S.C. § 7704(d)(1)(E). A list of MLPs can be found at *List of Current MLPs and MLP Funds*, MASTER LTD. P'SHIP ASS'N, https://www.mlpassociation.org/mlp-101/list-of-current-mlps/ (last visited Aug. 4, 2017).

partnership to transfer to other partners BIG and BIL that arose before the property was contributed to the partnership, and a partnership should not be able to transfer to new partners BIG and BIL that arose before a new partner joined the partnership. Furthermore, distributions and contributions of property to and from a partnership are generally tax free, but any gain or loss is preserved in either the property received or the remaining partnership interest.

These rules would mitigate many of the current weaknesses of Subchapter M, including the elimination of BIG on the distribution of appreciated property, the temporary allocation of taxable gains to new shareholders, and the temporary double benefit from taxable losses. This solution, however, is certainly not a costless panacea. Certain rules discussed below were not specifically designed to accommodate partnerships with many partners, frequent changes of ownership (such as MLPs in which ownership changes can occur multiple times per day), and a significant number of assets. Consequently, certain modifications to these rules are necessary to make them administrable; even then, they can only be implemented with sophisticated software.

One possibly significant consequence of requiring ETFs to be treated as partnerships for tax purposes is the potential application of the unrelated business taxable income (UBTI) provisions.[240] Entities such as pension plans, universities, 401(k) plans, and IRAs are generally exempt from tax,[241] but they are subject to tax at corporate rates on their UBTI.[242] Income from RICs does not constitute UBTI.

Passive investment income such as dividends, interest, income from notional principal contracts, options, and capital gains does not generate UBTI,[243] whether the tax-exempt entity receives the income directly or indirectly through a partnership.[244] Consequently, the investment income of an ETF treated as a partnership that is allocated to a tax-exempt investor should not generate UBTI.

If, however, an ETF treated as a partnership borrows to make a debt-financed investment, the income or gain from the investment is UBTI.[245] Property is debt-financed property if there is acquisition indebtedness during the taxable year.[246] Acquisition indebtedness refers to indebtedness

240. The author thanks Barnet Phillips IV for bringing this issue to his attention.
241. *See* 26 U.S.C. § 501(a) (2012).
242. *See id.* §§ 511(a)(1), 512–13.
243. *See id.* §§ 512(b)(1), (b)(5).
244. *See id.* § 512(c).
245. *Id.* §§ 512(c), 514(a).
246. *Id.* § 514(b)(1).

incurred to acquire the property.[247] To the extent an ETF treated as a partnership generates UBTI, this could dissuade institutional investors from investing in ETFs.

The following discussion describes these provisions, how they remedy the issues discussed above, including the separation of economic and taxable income and the elimination of BIG on the distribution of appreciated property, and highlights certain aspects that raise administrative concerns. The following sections also describe how publicly traded partnerships (PTPs) apply these rules. Even though some of the rules discussed below are currently being revised, the changes should not significantly affect their application to investment companies.

3. Section 704(c) and Reverse § 704(c) Allocations

Partnership taxable gains can arise from the sale of property that has been contributed to the partnership with BIG[248] or from the sale of property that has increased in value after contribution or purchase.

Taxable gain recognized upon the sale of partnership property that is attributable to BIG when the property was contributed to the partnership must generally be allocated to the partner who contributed the property.[249] Economic gains and losses as reflected in the partners' capital accounts arising after property has been contributed to or purchased by a partnership are generally ignored. If, however, there is a change in the ownership of the partnership interests, for instance, in connection with the contribution of money or property by a new or existing partner, or the partnership distributes cash or other property to a partner in consideration for a

247. *Id.* § 514(c)(1)(A). It also includes indebtedness incurred before or after the property was acquired "if such indebtedness would not have been incurred but for the acquisition" of the property. *Id.* §§ 514(c)(1)(B)–(C). The IRS has issued private letter rulings that hold that short-term borrowings to facilitate redemptions and not making additional investments did not constitute acquisition indebtedness. *See* I.R.S. Priv. Ltr. Rul. 2003-20-027 (Feb. 20, 2003); I.R.S. Priv. Ltr. Rul. 2002-35-042 (May 21, 2002).

248. Property can generally be contributed tax-free to a partnership. *See* 26 U.S.C. § 721(a) (2012). If no gain or loss is recognized upon contribution of property, the contributing partner will take a carryover basis in her partnership interest. *See id.* § 722.

249. *See id.* § 704(c)(1)(A). This allocation is done by maintaining separate tax and book capital accounts and by requiring the allocation of any realized taxable gain first to the partner who contributed the property to the extent of the BIG when the property was contributed. Treas. Reg. § 1.704-3(b)(1) (2017). If the amount of taxable gain is less than the partner's book-tax difference attributed to the contributed property, the partnership may be able to make allocations to correct the difference. *See id.* § 1.704-3(c)–(d) (describing the use of the traditional method with curative allocations and the remedial method). The contributing partner is also allocated gain if the property is distributed to another partner within 7 years of being contributed. *See* 26 U.S.C. § 704(c)(1)(B); *infra* Parts III.E.6–7.

partnership interest, the partnership may adjust the capital accounts.[250] The partners' capital accounts can also be adjusted to reflect changes in the value of partnership assets if "substantially all of the partnership's property . . . consists of stock, securities, . . . options, [or] futures . . . that are readily tradable on an established securities market."[251]

In these cases, there is a so-called "book-up" whereby the partnership marks to market its assets for book purposes and allocates book gains and losses to the partners.[252] In a hedge fund, for example, this can occur daily, weekly, or at least every break period, which is when partner entries and exits are permitted.[253] To ensure that tax gains or losses are properly allocated to the partner that has economically earned or borne them, a partnership must allocate the *book* gains and losses among the partners following the same approach for § 704(c) gains and losses.[254] These gains and losses are referred to as *reverse § 704(c) allocations*.[255] When the property is sold, the *tax* gains and losses will be allocated to the partners to whom the book gains and losses were allocated.

Although § 704(c) applies on a property-by-property basis,[256] securities partnerships can elect to aggregate gains and losses and apply § 704(c) on an aggregate basis.[257] The § 704(c) regulations specifically

250. *See* Treas. Reg. §§ 1.704-1(b)(2)(iv)(f)(5)(i)–(ii) (2017).

251. *Id.* § 1.704-1(b)(2)(iv)(f)(5)(v).

252. These adjustments are not mandatory, but the regulations caution that if the partnership does not make these adjustments in the case of an acquisition or relinquishment of a partnership interest, the partnership must still generally allocate taxable gain and loss under § 704(c) principles. *See id.*; *see also id.* § 1.704-1(b)(5), ex. 14(iv) (discussing the consequences of not booking up upon the entrance of a new partner and allocating equally all taxable gain attributable to the sale of a partnership asset). For a discussion of this issue, see Howard E. Abrams, *Reverse Allocations: More Than Meets the Eye*, 5 J. PASSTHROUGH ENTITIES. 35, 41 (2002).

253. According to one commentator, revaluations are a "fact of life, rather than an isolated event, for an investment partnership." Stephen B. Land, *Revaluations Revisited: Partnership Allocations and the Demise of the Ceiling Rule*, 54 TAX. LAW. 241, 245 (2001).

254. *See* 26 U.S.C. § 704(c).

255. Treas. Reg. § 1.704-3(a)(6) (2017).

256. *Id.* § 1.704-3(a)(2).

257. A securities partnership includes an investment partnership if "the partnership makes all book allocations in proportion to the partners' relative book capital accounts." *Id.* § 1.704-3(e)(3)(iii)(A). This definition was expanded in Rev. Proc. 2007-59, 2007-40 I.R.B. 745 (2007). Most ETFs, but not all, would satisfy the definition of a securities partnership. One commentator stated that "[a]lthough many (perhaps most) hedge funds do not qualify as securities partnerships, almost all of them allocate reverse § 704(c) gains and losses on an aggregate basis." Andrew W. Needham, *Portfolio 736-2nd: Hedge Funds*, 736 Tax Mgmt. Portfolio (BNA) § V.C.3. The New York State Bar Association has argued for expanding the class of partnerships eligible to use aggregation because separate allocation can be "unduly burdensome" for partnerships with many assets. *See, e.g.*, N.Y. State Bar Ass'n Tax Section, *Report on Aggregation Issues Facing Securities Partnership Under Subchapter K*, 17 (2010) [hereinafter NYSBA]. *But see* Letter from Terrence Floyd Cuff,

approve two methods of aggregation: partial netting and full netting.[258] In partial netting, tax gains and losses are separately aggregated and then the aggregate tax gains and aggregate tax losses are allocated among the partners to reduce book-tax disparities of the partners as reflected in each partner's revaluation account.[259] In full netting, tax gains and losses are netted, and net tax gain or net tax loss is allocated among the partners to reduce book-tax disparities of the partners as reflected in each partner's revaluation account.[260]

Example 4

A and *B* each contribute \$100 to *AB* partnership, which purchases security 1 and security 2 for \$100 each. Later when security 1 depreciates to \$50 and security 2 appreciates to \$350, *C* contributes \$200 for a 1/3 interest in *ABC* partnership. The entry of *C* will cause a reverse § 704(c) allocation of \$100 to each of the capital accounts of *A* and *B*, while their tax capital accounts and outside basis each remains at \$100, whereas *C* will have a book and tax capital account of \$200. If, for example, both securities were immediately sold for their FMV, the net \$200 of tax gain would be allocated only to *A* and *B*, with the result that their book and tax capital accounts would then be equal.

The following table shows the partnership accounts immediately after *C*'s contribution.

	Assets			Capital Accounts	
	Tax	**Book**		**Tax**	**Book**
Cash	200	200	*A*	100	200
Security 1	100	50	*B*	100	200
Security 2	100	350	*C*	200	200
	400	600		400	600

Reverse § 704(c) allocations are intended to ensure that the *tax* gains or losses associated with the economic gains or losses that arose before

Partner, Loeb & Loeb LLP, to Michael Mundaca, Assistant Sec'y (Tax Policy), Dep't of the Treasury (Mar. 30, 2011) (available on Lexis, 2011 TNT 66-24) (arguing that aggregation should be eliminated for securities partnerships and suggesting that the administrative burden of complying with property-by-property accounting may not be overwhelming given modern computer software).

258. Treas. Reg. § 1.704-3(e)(3)(iv)–(v). Each partner's book-tax differences are reflected in the partner's revaluation account, which is merely the difference between a partner's capital account and tax capital account.

259. *Id.* § 1.704-3(e)(3)(iv). Aggregate tax gains are allocated to partners with positive revaluation accounts, and aggregate tax losses are allocated to partners with negative revaluation accounts.

260. *Id.* § 1.704-3(e)(3)(v). For an illustration of the different tax consequences associated with partial and full netting, see *id.* § 1.704-3(e)(3)(ix) exs. 1–2. Most hedge funds apparently follow full netting. *See* Needham, *supra* note 257, § V.B.

certain changes in a partnership, e.g., a new partner entering the partnership, will be allocated to the partners that benefited from economic gains or bore economic losses. Thus, in Example 4, *A*'s and *B*'s net economic gains are $100 each when *C* enters the partnership, and their capital accounts are adjusted by these amounts. When the tax gains associated with these book adjustments are realized, they must be allocated to *A* and *B*. In this example, after the entrance of *C* and a sale of both securities for their book value, inside basis and outside basis will both equal $600.[261]

Requiring ETFs and mutual funds to make reverse § 704(c) adjustments may better align taxable and economic gains and losses and thereby prevent the allocation of taxable gains to new shareholders. Although in this example the adjustments are straightforward, for an ETF or mutual fund, the adjustments would be more complex primarily because of the number of ownership changes. Publicly traded commodity investment partnerships with ETF features typically mitigate the administrative burdens of reverse § 704(c) allocations by requiring revaluations only monthly.[262] Because mutual funds and ETFs maintain their books on a daily fair value basis,[263] however, many of the complications that arise in making reverse § 704(c) allocations for companies that operate businesses, for example, allocating depreciation deductions and valuing assets, disappear.

Similar to reverse § 704(c) allocations, publicly traded partnerships also generally allocate taxable income on a monthly basis.[264] When a

261. After a sale of securities 1 and 2, the total taxable gain of $200 would be allocated to *A* and *B*, and their adjusted bases in the partnership would increase to $200 each. *See* 26 U.S.C. § 705(a)(1)(A) (2012). The resulting taxable gain or loss is required to be allocated to reduce the book-tax disparity of the partners. *See* Treas. Reg. §§ 1.704-3(e)(3)(iv)(C), 1.704-3(e)(3)(v)(C). In this example, whether the partnership applied reverse § 704(c) allocations on an asset-by-asset or aggregate basis, the total taxable gain is allocated to *A* and *B*. If a partnership elects aggregation, it is possible for a partner to be allocated taxable gain that arose before the partner entered the partnership if the partner has a book-tax disparity. This result occurs because aggregation treats all gains equally. That is, the identity of the particular asset is irrelevant. For an illustration, see Needham, *supra* note 257, § V.C.

262. *See, e.g.*, ProShares Tr. II, Common Units of Beneficial Interest (424BN3) 75–76 (Mar. 28, 2017) (describing monthly revaluations convention). The revaluations are done not based on the FMV of the assets at the time of the revaluations, as required by regulations, but instead based on the creation or redemption price of shares during the month. *Id.* at 75. This approach, while viable for ETFs, would not be viable for mutual funds because mutual funds must stand ready to make daily redemptions at NAV.

263. *See supra* Part II.C.1.

264. *See, e.g.*, ProShares Tr. II, *supra* note 262, at 79. The taxable income and losses are allocated by the number of shares owned as of the close of the last trading day of the preceding month. Thus, a shareholder who sells his shares during the month could be allocated taxable income or loss that arose after the shareholder sold his shares. *Id.*

partner's ownership interest changes in the case of a sale or partial liquidation, the partnership must adjust the partner's share of its tax items to take into account the partner's varying interest in the partnership. The partnership can either close its books on an interim basis or prorate on a daily basis the year-end tax items.[265] Regardless of whether a PTP chooses to use either the proration or interim closing-the-books method, a PTP may treat transfers of PTP interests as occurring on the first day of the following month.[266] This means that a partner that sells its interest on the first of the month can be allocated an additional month of tax items.

4. Distributions of Cash and § 734

Although reverse § 704(c) allocations help to match taxable gains and losses with economic gains and losses, certain transactions, such as the distribution of cash or property, can cause a divergence between inside basis and outside basis and possibly shift taxable gains or losses to partners who have not benefited from or borne them. To illustrate, assume that immediately after *C* enters the partnership, $200 is distributed to partner *A* in liquidation of his interest. *A* will recognize $100 of gain (amount realized of $200 less basis of $100).[267] Immediately after the distribution, the partnership's tax and capital accounts will be:

	Assets			**Capital Accounts**	
	Tax	**Book**		**Tax**	**Book**
Security 1	100	50	*B*	100	200
Security 2	100	350	*C*	200	200
	200	400		300	400

Since the distribution of property generally does not affect the partnership's basis in its property after the distribution,[268] the partnership's inside basis is $200, but the remaining partners' total outside basis is now

Partnership income is generally required to be allocated between transferors and transferees or among partners if their interest changes on a daily basis, although a semimonthly convention may be used. *See* Treas. Reg. §§ 1.706-4(c)(1)–(2) (2015).

265. *Id.* § 1.706-4(a). The default rule is the interim closing method. *Id.* Extraordinary items, such as capital gains, must be allocated among the partners on the day that they are taken into account and thus may not be prorated. *Id.* § 1.706-4(e). A partnership must generally use the calendar day convention for either the interim closing of the books or proration option, but may adopt either a semimonthly or monthly convention if it uses the interim closing method. *Id.* § 1.706-4(c)(3)(i). A PTP may use any convention with respect to either variation during the taxable year. *Id.* § 1.706-4(c)(3)(ii).

266. *Id.* § 1.706-4(c)(2)(iii).

267. *See* 26 U.S.C. § 731(a)(1) (2012).

268. *See id.* § 734(a) (stating that the "basis of partnership property shall not be adjusted" for distribution of property to a partner unless the partnership has a § 754 election in effect).

$300. If the securities were immediately sold for $400, there would be $250 of taxable gain and $50 of taxable loss. *B* would be allocated the first $100 of taxable gain to eliminate *B*'s book-tax difference, and the remaining $150 would be split between *B* and *C*, as would the $50 of loss. Each of *B*'s and *C*'s outside basis would then increase to $250, but the total value inside the partnership would only be $400.

Although *A*'s share of inside basis was $100, when *A*'s interest was liquidated, *A* removed $200 of basis from the partnership. Because *A* removed more than its share of inside basis, *A* left too little basis and too much gain in the partnership for the remaining partners. Consequently, *B* and *C* will be temporarily overtaxed by $100 if the securities are sold for their book value, which will not be rectified until they either sell their interests or the partnership is liquidated.

Given that a mutual fund generally distributes cash in redemption of a shareholder's interest at NAV, if a mutual fund were taxed as a partnership, these differences between inside and outside basis would continually arise as they do currently under Subchapter M, and the case for switching from Subchapter M to Subchapter K may not be as strong. A partnership, however, can elect under § 754 to apply special rules that are intended eliminate the inside-outside basis divide that can arise in distributions of cash and property and sales of partnership interests.[269]

In the previous example, the distribution to *A* of $200 caused *A* to recognize $100 of gain but also created a $100 difference between the inside basis of the partnership and the total outside basis of the partners. This occurred because *A* removed $200, which is $100 more than his share of inside basis. If the partnership makes a § 754 election, it is required under § 734 to adjust the tax basis of partnership property when a partner recognizes gain by receiving cash greater than its basis in the partnership.[270]

When *A* recognizes gain upon receiving cash in excess of its basis in its partnership interest, the partnership must increase the basis of its property by the gain recognized.[271] The basis adjustment prevents the same gain that *A* recognized from being taxed again to the remaining partners when the partnership sells its property.[272] Returning to Example 4, the

269. *See id.* § 754.

270. Whether or not a partnership has § 754 election in effect, a partnership is required to reduce the basis of its property if a partner either recognizes a loss of greater than $250,000 upon liquidation of its partnership interest or increases the basis of property received in liquidation by more than $250,000. *Id.* § 734(d)(1).

271. *Id.* § 734(b)(1).

272. Regulations under § 755 require in this case the adjustment to be made solely to capital gain property and then to property with BIG in proportion to BIG (but only to the extent of BIG) with any excess allocated among the properties in proportion to their FMV. Treas. Reg. §§ 1.755-1(c)(1)(ii), 1.755-1(c)(2)(i) (2017).

partnership would increase the basis of security 2 from $100 to $200 and thereby eliminate the $100 of gain that *A* recognized when it received cash in excess of its basis. After the basis adjustment, there would be $100 of net BIG in the partnership's assets, which exactly equals the difference between outside and inside basis.[273]

	Assets			Capital Accounts	
	Tax	Book		Tax	Book
Security 1	100	50	*B*	100	200
Security 2	200	350	*C*	200	200
	300	400		300	400

These examples show how reverse § 704(c) allocations ensure that the taxable gains and losses associated with economic gains and losses that arise before a new partner joins the partnership or changes his or her partnership interest are taxed to the partners who have benefited from the economic gains or borne the economic losses. Section 734 adjustments ensure that taxable gains and losses realized upon the distribution of cash to a partner are not temporarily taxed again or provide a temporary benefit to other partners.

Book-ups, book-downs, and § 734 adjustments ameliorate many of the uneconomic tax results that can arise with mutual funds, because mutual fund shareholders generally acquire their interests solely for cash and receive cash when redeeming from a fund. It is certain, however, that § 734 would significantly increase the administrative burden for an ETF. In fact, most securities partnerships do not make a § 754 election because of the increased accounting burdens even though there could be tax benefits for the partners, although PTPs always make a § 754 election to ensure that the PTPs' interests are fungible.[274] To ameliorate these

273. If both securities were immediately sold after the § 734 adjustment, there would be $150 of gain and $50 of loss. If the partnership elected partial netting, partner *B* would be allocated $125 of gain ($100 to eliminate the revaluation account and one half of the remaining $50), and $25 of loss. *C* would be allocated $25 of gain and $25 of loss. If the partnership elected full netting, the net $100 of gain would be allocated solely to *B*. In this example, partial and full netting yield the same results. Similarly, if *A* had recognized *loss* upon the liquidation of its partnership interest and the partnership had a § 754 election in effect, the partnership would *reduce* the basis of partnership property to prevent the same loss recognized by the departing partner from being used temporarily by the remaining partners. When loss is recognized, the departing partner removes less than its share of inside basis and therefore leaves too little gain or too much loss inside the partnership. *See* 26 U.S.C. § 734(b)(2)(A). The decrease in basis is made solely to capital gain property and then to property with BIL in proportion to BIL (but only to the extent of each property's BIL) with any excess allocated among the properties in proportion to their adjusted bases. Treas. Reg. §§ 1.755-1(c)(1)(ii), 1.755-1(c)(2)(ii).

274. NYSBA, *supra* note 257, at 27. For a discussion of the fungibility issue for PTPs, see Deborah Fields et al., *Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part IV—*

burdens, some commentators have suggested that a securities partnership should be able to treat the § 734 adjustments as a separate asset and then recovered over some period by adjusting the partnership's income.[275]

These same tax issues, however, would still exist for closed-end funds and ETFs because their non-AP owners dispose of or acquire their interests on an exchange and not from the fund. Section 743 addresses adjustments to partnership property when partnership interests are purchased or sold.[276]

5. Sales and Acquisitions of Partnership Interests and § 734

In the absence of a § 754 election, a partnership does not adjust the basis of its property for gain or loss recognized when a partner sells a partnership interest.[277] In addition, the purchasing partner inherits the selling partner's tax and book capital accounts, and these accounts are not adjusted to reflect BIG or BIL in the partnership's assets, unlike the case of a contribution or distribution of cash or property.[278]
If the basis of partnership property is not adjusted to reflect gain or loss recognized by a selling partner, a purchasing partner can be taxed on gains or benefit from losses that arose prior to the purchase of his interest.[279] Returning to the facts of Example 4, assume that *A* instead sells its partnership interest to *D* for $200 and recognizes $100 of gain.[280] Immediately after the sale, the total outside basis is $500 but the total inside basis is still $400, since the inside basis was not changed to reflect the $100 of gain.

D pays FMV, which reflects any unrealized gains and losses, for its partnership interest, but since the basis of the partnership property is not

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Secondary Offerings and the Impact of Public Trading), TAXES, Oct. 2010, at 32–36 (describing how the § 754 election helps to ensure that publicly traded units are fungible).

275. *Id.* at 29–34.

276. 26 U.S.C. § 743(a) (2012).

277. *Id.* A basis adjustment is mandatory if the partnership has a substantial built-in loss, i.e., the basis of its property is greater than its FMV by more than $250,000. *Id.* §§ 743(a), 743(d).

278. Treas. Reg. § 1.704-1(b)(2)(iv)(f) (2017) (stating that capital accounts are not adjusted for sales of partnership interests); *id.* § 1.704-1(b)(2)(iv)(*l*) (stating that the purchasing partner inherits the selling partner's capital account); *id.* § 1.704-3(a)(7) (requiring that BIG and BIL are allocated to the transferee partner as they would have been allocated to the transferor partner).

279. Since 2004, for property contributed to a partnership that has a BIL, only the contributing partner can use the loss. 26 U.S.C. § 704(c)(1)(A) (2012); Prop. Treas. Reg. § 1.704-3(f), 79 Fed. Reg. 3042 (Jan. 16, 2014). These rules do not apply to property for which a BIL is created pursuant to a reverse § 704(c) revaluation. Prop. Treas. Reg. § 1.704-3(f)(2)(i).

280. Because property held by a securities partnership is generally capital gain property, it is assumed that the gain would be capital. *See* 26 U.S.C. § 741(a) (2012).

adjusted, *D* will be taxed again on the unrealized gains and benefit from unrealized losses when they are realized. Thus, if securities 1 and 2 are sold for their book values, *D* and *B* will each be allocated $100 of taxable gain, which increases *B*'s and *D*'s outside basis in the partnership to $300 and $200, respectively. After the sales, the total outside basis will be $700, but the inside basis of the partnership assets will only be $600. Consequently, *D* will be temporarily overtaxed by $100, which will not be corrected until either *D* sells his partnership interest or the partnership is liquidated.

If, however, the partnership has a § 754 election in effect, the partnership increases the basis of its property solely with respect to the purchasing partner by the difference between *D*'s basis in the partnership interest ($200) and *D*'s share of inside basis ($100).[281] The partnership is required to establish a separate account for each property by allocating the total § 743 adjustment among each property of the partnership based on each property's BIG or BIL.[282]

The § 743 adjustment aims to ensure that a purchasing partner is not taxed on existing BIG or BIL when it is realized by the partnership by treating the partner as if he purchased a proportionate share of each partnership property. When the partnership sells property subject to a § 743 adjustment, the partnership computes gain or loss using the partnership's common basis in the property, and the taxable gain or loss is allocated among the partners pursuant to § 704(c). The taxable income or loss allocated to the purchasing partner is then adjusted by the § 743 adjustment.

In Example 4, *D* will have a $125 § 743 adjustment for security 1 and a negative $25 adjustment for security 2. If, for example, security 2 is sold for $410, the partnership will recognize a book gain of $60, which is

281. *Id.* § 743(b)(1)–(2). If a partnership has a substantial built-in loss, the § 743(b) adjustments are mandatory. *Id.* § 743(a), (d). The total § 743 adjustment is the difference between the transferee partner's basis in his partnership interest and his share of the adjusted basis of the partnership property. *See* Treas. Reg. § 1.743-1(b)(1)–(2) (as amended in 2004). For a partnership without liabilities, a partner's share of inside basis is merely the partner's tax capital account, or the amount of cash the partner would receive if the partnership were liquidated, increased by any tax losses, and decreased by any tax gain. *See id.* § 1.743-1(d)(1). In the table above, *D*'s tax capital account is $100, which is the same as the amount *D* would receive if the partnership were liquidated ($200), plus *D*'s share of tax loss ($25), less *D*'s share of tax gain ($125).

282. Even if the total § 743 adjustment is positive, some properties may have a negative adjustment and others a positive adjustment. Treas. Reg. § 1.755-1(b)(3)(ii) (as amended in 2017) (describing the allocation of § 743 adjustment among capital gain property). The adjustment does not affect capital accounts or the common basis of partnership property. *Id.* § 1.704-1(b)(2)(iv)(m)(2) (stating that § 743 adjustments are not reflected in capital accounts); *id.* § 1.743-1(j)(1) (stating that § 743 does not affect common basis of partnership property).

shared equally among the partners, and a taxable gain of $310, of which $145 is allocated to both *D* and *A* and $20 to *B*. Of the $145 gain allocated to *D*, however, *D* will reduce its gain by the $125 § 743 adjustment so that *D* includes in income only $20, which will also be *D*'s basis adjustment in its partnership interest.[283]

	Assets			Capital Accounts	
	Tax	Book		Tax	Book
Cash	200	200	*D*	100	200
Security 1	100	50	*B*	100	200
Security 2	100	350	*C*	200	200
	400	600		400	600

743 Adjustment for *D*	
Security 1	-25
Security 2	125

Again, in this simple example, the § 743 adjustments are straightforward because there is only one purchasing partner, *D*, and two partnership assets for which an adjustment must be tracked. In a partnership in which interests are frequently traded and which owns a multitude of assets, the administrative complexity required to track § 743 adjustments increases immensely. Each time a partnership interest is traded, a separate § 743 account for each asset must be newly created and tracked for the purchasing partner,[284] although for the selling partner the § 743 adjustment disappears when the interest is sold.[285]

Unlike reverse § 704(c) allocations, the § 743 regulations do not permit aggregate approaches for § 743 adjustments, and the adjustments must be made on an asset-by-asset basis. This increases significantly the administrative burdens. It has been suggested that § 743(b) adjustments be permitted to be done on an aggregate basis and then recovered based on turnover or realization.[286] If permitted, such an approach could significantly reduce the administrative burdens associated with § 754 elections.

The tax disclosures of publicly traded partnerships do not explain how § 743 adjustments are made other than to note that "certain

283. *Id.* § 1.743-1(j)(3) (stating that a partner's gain or loss from the sale of a partnership asset with a § 743 adjustment is the partner's share of the gain or loss minus any positive adjustment or plus any negative adjustment).
284. The reporting requirements for both the partnership and transferee partner are set out in Treas. Reg. § 1.743-1(k).
285. *Id.* § 1.743-1(f).
286. NYSBA, *supra* note 257, at 38–40.

conventions" are applied to reduce administrative complexity and the administrative costs of applying § 743 adjustments.[287] An additional administrative complexity required by § 743 is the need to obtain each owner's cost basis in its interests so that the fund can apply the § 743 adjustment. This can be challenging as fund interests may not be held in the name of the beneficial owner but instead in the name of the brokerage where the shares are held. Each purchaser generally is deemed to consent to obtaining this information from the record holder.[288]

The prior examples focused first on contributions of cash, distributions of cash, and sales of partnership interests. The framework set out above would, if applied to closed-end funds and mutual funds, improve the deficiencies of Subchapter M that result in the temporary over-taxation and under-taxation of shareholders caused by discrepancies between inside and outside basis. Adopting these provisions, however, would significantly increase administrative burdens. ETFs have the additional complication of in-kind contributions and distributions, but these same principles discussed above are also applicable to property contributions and distributions.

6. Contributions of Property

Contributions to mutual funds are generally made in cash, but they are generally made in kind to ETFs. Contributions of securities to ETFs taxed as RICs are generally taxable because the transferring AP does not have control of the ETF.[289] In contrast, the contribution of a diversified portfolio of securities to an investment partnership would likely be tax-free to the contributing partner, the partnership would take a carryover basis in the transferred securities, and the partner would take a carryover basis in the partnership interest.[290]

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287. *See, e.g.*, ProShares Tr. II, Prospectus (424B3) 76 (Mar. 28, 2017) (describing § 743(b) adjustments); Direxion Shares ETF Tr. II, Prospectus (Form S-1) (Dec. 14, 2016).

288. Direxion Shares ETF Tr. II, *supra* note 287, 51.

289. The exchanges probably do not qualify for tax-free treatment under § 351(a) because the AP that transfers securities is not in control of the ETF immediately after the transfer. *See* 26 U.S.C. § 351(a) (2012). Control requires ownership of 80 percent of the voting stock of the transferee corporation. *Id.* § 368(c).

290. *Id.* § 721(a) (stating that the transfer of property to a partnership is tax-free to the transferring partner); *id.* § 723 (stating that the partner takes a carryover basis in the partnership interest); *id.* § 733 (stating that the partnership takes a carryover basis in transferred property). Although transfers to a partnership that would constitute an investment company under § 351(e) are taxable exchanges, a transfer to ETFs would not be taxable because the transfers would generally not result in the diversification of an AP's interests as the AP would generally be transferring a diversified portfolio of securities that is identical to the portfolio of securities held by the transferee ETF. Treas. Reg. § 1.351-1(c)(6)(i) (as amended in 1967).

An AP's transfer of appreciated securities would raise the same issues discussed above with respect to the transfer of cash: the partnership would book up its assets and make any necessary reverse § 704(c) allocations for the existing partners. Any difference between the AP's basis in the transferred securities and their FMV would, when the securities are sold, be taxed to the contributing AP, and any existing BIG or BIL in the partnership's assets would be taxed only to the current partners.[291]

Permitting the tax-free transfer of securities to an ETF in accordance with normal partnership rules raises the specter of the so-called "mixing bowl rules," which aim to prevent shifting BIG in property to another party by contributing it to a partnership.[292] These rules apply if (1) contributed BIG or BIL property is distributed to a partner other than the contributing partner within seven years of being contributed,[293] or (2) other property is distributed to a partner that has contributed property with BIG.[294]

Given the normal tax-free treatment of in-kind distributions by a partnership, in the absence of the mixing bowl rules, a partner could contribute property with BIG and receive other property tax-free from the partnership or the BIG property could be distributed tax-free to another partner. A partner generally does not recognize any gain or loss on the distribution of property to a partner whether in complete or partial liquidation of the partner's interest in the partnership, except to the extent a partner receives cash in excess of basis.[295] To ensure that gain or loss does not disappear when property is distributed in a non-liquidating distribution, the partner takes a carryover basis in the property, but only to the extent of its basis in its partnership interest.[296] In the case of a liquidating distribution, the partner's interest in the property will be equal to it basis in the partnership.[297]

291. 26 U.S.C. § 704(c) (2012); Treas. Reg. § 1.704-3(e)(3) (2017).

292. Since the enactment of § 704(c)(1)(C), it is generally not possible to shift BIL on contributed property to other partners. *See* Prop. Treas. Reg. § 1.704-3(f), 79 Fed. Reg. 3042 (Jan. 16, 2014).

293. 26 U.S.C. § 704(c)(1)(B) (requiring the contributing partner to recognize gain upon distribution of contributed property to another partner within seven years).

294. *Id.* § 737(a)–(b). The contributing partner must recognize gain equal to the lesser of (1) the FMV of property received over the adjusted basis of the partner's interest in the partnership; or (2) the amount of gain that would be recognized by the contributing partner if all the property contributed by the partner within the last seven years (and still held by the partnership) were distributed to another partner. *Id.*

295. *Id.* § 731(a)(1)–(2) (providing that gain is recognized only if the money distributed exceeds the adjusted basis of the partner's interest; loss is only recognized if a partner's interest is liquidated and the partner receives only cash and certain ordinary income items).

296. *Id.* § 732(a)(1)–(2). The partner reduces its basis by money distributed and the adjusted basis of the distributed property to the partner.

297. *Id.* § 732(b).

Given that APs continually contribute to, and receive securities from, ETFs as part of the share creation and redemption processes, contributions to ETFs should be taxable as they are currently. This would relieve ETFs of the administrative burden of having to track any BIL or BIG upon contribution of property and to monitor potential application of the mixing bowl rules.[298]

7. Distributions of Property

Distributions of property by a partnership raise many of the same issues as distributions of cash. Distributions of property from a partnership are generally tax free to the partner, except if the partner receives cash in excess of his partnership interest or receives in liquidation only cash, unrealized receivables, and inventory.[299] To ensure that gain or loss is eventually recognized when the distributed property is sold, the partner takes a carryover basis in the property, limited to the partner's basis in his partnership interest, or if the property is received in liquidation of the partner's interest, the partner's basis in the property will be the partner's basis in his partnership interest.[300]

When a partnership distributes property in kind, the distributee partner can remove more than or less than his share of the inside basis and thereby leave too little or too much gain for the remaining partners. To illustrate, assume the same facts as Example 4, but security 1 has a basis of $50, security 2 has a basis of $150, and each has a FMV of $200. The partnership liquidates *A*'s interest by distributing security 2. Immediately after the distribution, *A* will have a basis of $100 in security 2, which ensures that when *A* sells security 2, he will recognize $100 of gain, which accurately reflects his economic gain. Immediately after the distribution, the partnership's accounts will be as follows:

298. For example, under proposed regulations, a partnership must separately track for each partner each forward § 704(c) layer and reverse § 704(c) layer. *See* Prop. Treas. Reg. § 1.704-3(a)(6)(i). For a discussion, see NYSBA, *supra* note 257, at 82–94.

299. 26 U.S.C. § 731(a)(1)–(2) (2012). If a partner receives cash in excess of basis, he will recognize gain. If a partner receives only cash, unrealized receivables, and inventory with a basis less than the partner's basis in his partnership interest, he will recognize loss. Under § 731(c), marketable securities are treated like cash. This provision would not apply to ETFs since an ETF would probably qualify as an investment partnership and any AP would be an eligible partner. *Id.* § 731(c)(3)(A)(iii).

300. *Id.* § 732(a)(1)–(2) (providing rules for distributions other than in liquidation of a partner's interest); *id.* § 732(b) (providing rules for distributions in liquidations). If more than one property is distributed, the partner's basis in its partnership interest must be allocated among the properties received. *See id.* § 732(c).

	Assets			Capital Accounts	
	Tax	Book		Tax	Book
Cash	200	200	*B*	100	200
Security 1	50	200	*C*	200	200
	250	400		300	400

A's basis in Security 2	**$100**
FMV of Security 2	**$200**

The distribution of security 2 has resulted in $150 of basis leaving the partnership, which is greater than *A*'s outside basis immediately before the distribution ($100). *A* has thus removed more than his share of the partnership's inside basis and therefore has left too much gain for the remaining partners: if the partnership immediately sold security 1 for $200, there would be $150 of gain, $125 of which would be allocated to *B* and $25 to *C*. The total outside basis of the partnership would be $450, but the FMV of the partnership interests would only be $400, resulting in a temporary over-taxation of *B* and *C*.

Similar to the consequences that occur when a partner receives cash greater than its basis, if a partnership has a § 754 election in effect, under § 734 the partnership increases the basis of security 1 by $50, the difference between *A*'s outside basis immediately before the distribution ($100) and the basis of the distributed property ($150).[301] Consequently, the partnership's inside basis will now equal the partners' total outside basis.[302]

Similarly, if the redeeming partner removes less than its share of inside basis, the partnership must decrease the basis of its property. For instance, if security 1 with a FMV of $200 and an AB of $50 were distributed to *A* in liquidation of its interest, *A* would take a $100 basis in the property under § 732(b). Since the basis of the property in the hands of the partner is increased by $50, the property's BIG is decreased by $50. If the partnership has a § 754 election in effect, the partnership must decrease the basis of its property by $50 to ensure that the gain is eventually taxed.[303]

If ETFs were required to adopt partnership tax principles, they could continue to distribute property to redeeming APs without triggering immediate fund level gains. The basis adjustment mechanisms of §§ 732 and 734(b), however, ensure that the BIG in the distributed property is eventually taxed once.

301. *See id.* § 734(b)(1)(B).
302. The rules for allocating the basis adjustment among a partnership's property are set forth in Treas. Reg. § 1.755-1(c) (2017).
303. *See* 26 U.S.C. § 734(b)(2)(B).

IV. CONCLUSION

The exemption in § 852(b)(6) from the recognition of gain on the distribution of appreciated property by RICs should be eliminated. It provides an unfair tax subsidy for ETFs and encourages the transfer of capital from other kinds of investment vehicle to ETFs. It also unfairly benefits high-net-worth owners of ETFs. This article has discussed various alternatives, including outright repeal, reducing the basis of a fund's remaining assets by any unrecognized gain in the distributed property, carrying over the basis of distributed property, limiting the basis of securities that are distributed, and finally, requiring ETFs and ETF-like mutual funds to be subject to partnership tax principles. Requiring ETFs and mutual funds to be subject to partnership tax rules is the best option to ameliorate many of the current deficiencies of Subchapter M.

Annex A

Fund Name		Ann. Rep. Date	Total Common Stock (FMV)	Cost (Tax)	Net BIG/BIL (Tax)	In-Kind Redemptions	Capital Gains (Losses) on In-kind Redemptions (Book)	Capital Gains Distrib-uted
SPDR S&P 500 ETF Trust		9/30/16	$197,172,469,106	$206,955,128,384	($9,782,659,278)	$167,729,988,725	$11,282,034,332	0
iShares Core S&P 500 ETF		3/31/16	70,976,021,930	68,576,090,281	3,305,312,461	11,618,177,755	3,121,991,526	0
Vanguard Total Stock Market ETF	a	12/31/15	398,105,564,000	290,340,198,000	112,650,200,000	18,635,547,000	11,693,991,000	0
iShares MSCI EAFE ETF		7/31/16	59,146,251,563	62,513,423,525	(2,688,661,915)	418,998,579	134,395,533	0
Vanguard S&P 500 ETF	b	12/31/15	218,575,502,000	137,491,163,000	81,871,357,000	7,643,689,000	5,126,301,000	0
Vanguard FTSE Emerging Markets ETF	c	10/31/16	61,977,966,000	62,796,859,000	466,179,000	1,021,634,000	(215,435,000)	0
PowerShares QQQ ETF		9/30/16	39,515,775,492	41,714,492,789	(2,198,717,297)	93,540,742,447	3,709,338,441	0
Vanguard FTSE Developed Markets ETF	d	12/31/15	53,038,379,000	53,837,436,000	140,922,000	1,312,690,000	548,502,000	0
iShares Russell 2000 Index (ETF)		3/31/16	25,279,718,153	38,165,289,773	(8,511,269,760)	95,549,624,527	2,629,600,032	0
iShares Russell 1000 Value ETF		3/31/16	26,278,927,194	25,770,369,399	920,628,040	5,489,770,008	1,832,641,443	0
iShares Core S&P Mid-Cap ETF		3/31/16	26,532,528,609	28,421,805,131	(155,335,046)	4,575,693,877	1,107,903,068	0
iShares Russell 1000 Growth ETF		3/31/16	29,648,642,929	24,530,967,211	6,071,780,107	4,629,100,278	2,003,289,790	0
Vanguard Value ETF	e	12/31/15	37,602,769,000	32,338,864,000	5,330,636,000	3,671,355,000	1,249,696,000	0
iShares Core S&P Small-Cap ETF		3/31/16	17,285,198,819	18,681,877,306	496,301,866	2,563,015,249	943,517,082	0
iShares MSCI Emerging Markets ETF		8/31/16	29,507,455,345	34,000,259,007	(1,524,588,409)	2,807,400,251	6,837,166	0
Vanguard Growth ETF	f	12/31/15	49,873,048,000	33,457,681,000	16,646,622,000	3,869,116,000	1,947,855,000	0
The Financial Select Sector SPDR Fund		9/30/16	11,954,401,676	12,779,063,214	(210,494,400)	18,017,285,894	109,964,107	0
Vanguard Dividend Appreciation Index Fund	g	1/31/16	22,846,842,000	20,993,088,000	1,877,381,000	7,458,655,000	2,835,981,000	0
SPDR S&P MIDCAP 400 ETF TRUST		9/30/16	17,158,987,894	18,897,118,533	(1,738,130,639)	23,125,571,338	1,193,675,327	0
iShares Core MSCI Emerging Markets ETF		8/31/16	15,379,184,895	17,005,902,297	(185,307,234)	N/A	N/A	0
Vanguard High Dividend Yield Index Fund	h	10/31/16	21,297,097,000	18,787,789,000	2,583,223,000	1,418,566,000	472,041,000	0
Energy Select Sector SPDR		9/30/16	14,884,360,786	18,360,649,176	(3,360,653,388)	12,118,524,503	697,504,243	0
iShares Select Dividend ETF		4/30/16	14,617,215,013	12,318,571,908	2,310,971,569	2,556,974,278	773,836,016	0
iShares Russell 1000 ETF		3/31/16	14,780,068,614	14,219,848,359	935,201,866	2,123,405,551	778,191,067	0
Vanguard Mid-Cap Index Fund	i	12/31/15	65,581,084,000	54,847,006,000	11,337,556,000	9,059,213,000	4,221,102,000	0

Total Net Gains **$58,420,188,173**

Vanguard Funds Only **$27,880,034,000**

Notes

a Figures are total fund assets. ETF shares net assets were $40,439,887,000
b Figures are total fund assets. ETF shares net assets were $44,636,253,000
c Figures are total fund assets. ETF shares net assets were $29,287,676,000
d Figures are total fund assets. ETF shares net assets were $29,287,676,000
e Figures are total fund assets. ETF shares net assets were $18,648,401,000
f Figures are total fund assets. ETF shares net assets were $18,771,004,000
g Figures are total fund assets. ETF shares net assets were $15,497,197,000
h Figures are total fund assets. ETF shares net assets were $12,984,375,000
i Figures are total fund assets. ETF shares net assets were $12,984,375,000