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Recent IRS Guidance Regarding “Tax-Aware” Strategies

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Treasury and the IRS are taking a closer look at “tax-aware” investing strategies. This article examines Revenue Ruling 2026-20 and Notice 2026-62, including transactions involving exchange traded funds, section 852(b)(6), selective derivative terminations, foreign currency elections, and straddles, as well as potential governmental actions and considerations for fund managers and investors.

The growth of “tax-aware” investing has not gone unnoticed by Treasury and the IRS. On September 28, 2026, the IRS released Revenue Ruling 2026-20 (the “**Ruling**”) and Notice 2026-62 (the “**Notice**”), addressing certain “tax-aware” investment strategies that have received significant attention by the press in recent months, including being addressed by Treasury officials at a recent industry conference.

The Ruling

The Ruling addresses a so-called “section 351 conversion transaction.” In the Ruling, an investor contributes appreciated securities to an exchange traded fund (“**ETF**”) treated as a regulated investment company (“**RIC**”) in a transaction intended to qualify as a tax-free transfer under section 351.¹ Shortly thereafter and pursuant to an overall plan, the ETF issues shares to a person serving as an “authorized participant” in exchange for securities that are consistent with the ETF’s investment thesis or cash that the ETF intends to use to acquire such securities. Within a short period of time after that, the ETF redeems those shares in exchange for securities transferred to the ETF by the investor. The redemption is intended to qualify under section 852(b)(6) and thereby avoid the recognition of gain on the appreciated securities disposed of by the ETF.² Upon completion of the planned transactions, the ETF holds a portfolio of securities that is consistent with its investment thesis and materially different from the portfolio transferred by the investor—and purportedly accomplishes this change in the investor’s holdings without triggering the gain embedded in the appreciated securities.

¹ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

² Section 311(a) generally provides that no gain or loss is recognized on the distribution of property with respect to its stock. Section 311(b) generally requires corporations to recognize gain upon the distribution of built-in gain property. Under section 852(b)(6), section 311(b) does not apply to any distribution by a regulated investment company if the distribution is in redemption of its stock upon the demand of the shareholder.

The Ruling concludes that the transitory contribution of appreciated securities to an ETF followed by a redemption of the authorized participant with such securities does not qualify for the purported nonrecognition treatment and, under substance-over-form and step transaction principles, is recharacterized in a way that results in the investor realizing gain under section 1001. As support for its conclusion, the Ruling cites guidance where “transitory” transfers of property through a “conduit” entity were disregarded. But what if the ETF is not merely a conduit and the transfers are not transitory? One could imagine much more sympathetic transactions in which only a small portion of the appreciated securities contributed by the investor are used to redeem the authorized participant and such redemptions occur over a meaningful period of time. Therefore, a significant question is how far the Ruling’s analysis should be taken.

The Notice

The Notice describes transactions that Treasury and the IRS believe may produce results that are inconsistent with the purpose and proper application of the relevant federal tax rules. The Notice requests comments and information regarding the enumerated transactions, which broadly fall into two categories: (i) transactions involving ETFs’ use of section 852(b)(6) in a way that may not have been intended by Congress and (ii) transactions structured through product selection, identifications, and/or elections to create a pattern of capital gains and ordinary losses. These transactions are briefly described below.

Section 852(b)(6) Transactions

Treasury and the IRS suggested that section 852(b)(6) is being used in ways that may not have been intended in the following transactions: section 351 conversion transactions, partnership iterations of the section 351 conversion transaction, dividend avoidance transactions, avoidance of RIC qualifying income rules, and box spread funds.

Section 351 Conversion Transactions

As described in the Ruling, in a section 351 conversion transaction, a taxpayer holds appreciated stock and, pursuant to an overall plan, seeks to use a combination of two nonrecognition provisions to avoid recognizing the gain on the appreciated shares.³

- **Limitations:** ETFs routinely use section 852(b)(6) to avoid entity level gain recognition through so-called “heartbeat trades.” The Notice does not address and expresses no views on such ordinary in-kind distributions, although it does indicate any guidance “will respect market expectations with respect to conventional, long-established tax planning.” The Notice also states that it does not address transactions in which a section 351 transaction is used to seed a newly established ETF with assets that are consistent with the ETF’s investment thesis and that are intended and expected to be retained by the ETF absent a substantial change in circumstances (including an unexpected change in market or business conditions).

Partnership Iterations of the Section 351 Conversion Transaction

The Notice also describes a partnership variation of section 351 conversion transaction. In this iteration, investors with appreciated securities that are not sufficiently diversified first contribute those securities to a partnership in a transaction intended to qualify as tax-free under section 721(a). The partnership invests at least 20 percent of its assets in property other than stock or securities. As a result, the investors take the position that the partnership would not be treated as an investment company under

³ Although the strategy purports to avoid recognizing gain on the appreciated shares, the gain does not disappear entirely. The ETF shares held by the taxpayer in these transactions would retain a built-in gain that would be recognized if they were ever sold.

section 351(e) and that section 721(b) does not apply.⁴ As part of the same plan, the partnership contributes a portfolio (which is diversified) to a newly formed ETF in a transaction intended to qualify under section 351.⁵ The investors take the position that these transactions allow them to exchange their appreciated securities for an indirect interest in an ETF with a materially different portfolio without recognizing the built-in gains.

- **Limitations:** The Notice indicates that Treasury and the IRS are considering guidance that would deny nonrecognition for the contributions to the partnership or otherwise recharacterize the transactions based on their substance.

Dividend Avoidance Transactions

In these transactions, an ETF pursues its investment directive by holding interests in lower tier ETFs that create the desired economic profile and uses section 852(b)(6) to effectively convert currently recognizable ordinary dividend income into deferred capital gains income. For example, an ETF (parent ETF) may seek a return that tracks an index by investing in one or more acquired ETFs that track the same index. The trading price of an acquired ETF generally reflects the value of the ETF's expected dividend payments. Shortly before the record date for payment of a dividend by an acquired ETF: (i) the parent ETF issues a creation unit to an authorized participant in exchange for property such as cash or shares of a different ETF that tracks the same index and (ii) the parent ETF subsequently distributes to the authorized participant the shares of the acquired ETF in redemption of the parent ETF shares. If the property contributed by the authorized participant is cash, the parent ETF invests in shares of a different ETF that tracks the same index. The parent ETF takes the position that it avoids recognition of dividend income, and parent ETF shareholders take the position that they recognize no income or capital gain until they dispose of their parent ETF shares, at which time they recognize capital gain or loss based on the difference between their basis in the parent ETF shares and the amount realized on disposition.

- **Limitations:** The Notice does not address ETFs that invest in other ETFs that track different indices.

Avoidance of RIC Qualifying Income Rules

ETFs structured as RICs are required to meet certain asset diversification and gross income tests. The Notice indicates that some ETFs have invested in assets that would produce nonqualifying income if sold, such as commodities or digital assets, and have used the mechanics of section 852(b)(6) to avoid recognizing gains that would be nonqualifying income. For example, if the ETF held an appreciated digital asset, the ETF might (i) issue a creation unit to an authorized participant in exchange for cash and (ii) distribute to the authorized participant the appreciated digital asset in redemption of the creation unit. The combination of (i) and (ii) has the economic effect of a sale, but if the steps were respected the ETF would avoid the recognition of nonqualifying gain.

- **Limitations:** The Notice indicates it is not intended to address the common strategy of using a controlled foreign corporation to make investments in assets that would produce nonqualifying income.

⁴ Section 721(b) turns off the normally applicable section 721 nonrecognition rules when property is contributed to a partnership that would be an "investment company" as defined under section 351(e). Treas. Reg. section 1.351-1(c)(1)(ii) provides that an entity is not an investment company if it is not a RIC, real estate investment trust ("REIT"), and no more than 80 percent of the value of its assets are held for investment and are readily marketable stocks or securities, or interests in RICs or REITS.

⁵ To the extent this leg of the transaction aligns with the situation described in the Ruling, it would presumably be treated similarly.

Box Spread Funds

In these transactions, the ETF uses a “box spread” option strategy to synthetically create a time-value-of-money return (typically a return tied to treasury yields). In a “box spread,” the ETF enters into a combination of four options on the same underlying property that, in the aggregate, product a return similar to a short-term interest rate. In one iteration of the strategy, the box spread is constructed using contracts that do not qualify as section 1256 contracts and the ETF separates the components of the box spread and distributes the options in an unrealized gain position in a section 852(b)(6) transaction. This is intended to allow the ETF to avoid the recognition of its economic gain from the box spread transaction, and enable its investors to recognize their economic income on their investment as capital gain and only when the investor sells its shares in the ETF (thus, this strategy creates a character and timing benefit). The use of non-section 1256 contracts ensures that there is not a mark to market event on the gain contracts when they are used in a redemption transaction. A similar transaction involves an ETF executing a box spread using section 1256 contracts and also a separate straddle using non-section 1256 contracts. In this version, the gain leg of the non-section 1256 contract straddle is disposed of without gain recognition using section 852(b)(6) and the loss position is used to offset the gains on the box spread transaction.

Capital Gain, Ordinary Loss Transactions

The other broad class of transactions covered by the Notice are transactions that, in the words of Treasury and the IRS “use technical differences among economically similar financial products or payments, or timing and identification rules, to create a pattern of generating capital gain and ordinary loss.” These transactions include selective NPC terminations, retroactive section 988(a)(1)(B) elections, and straddle transactions.

Selective NPC Terminations

This strategy involves the trading of notional principal contract (“NPC”) derivatives in a manner that takes into account the different tax characterizations of payments made to terminate an NPC (which produce capital gain or loss) and payments made pursuant to the terms of the NPC (which produce ordinary income or deduction). The Notice describes a strategy where loss contracts are allowed to mature or run to the next payment date (and therefore produce ordinary losses) while gain contracts are terminated prior to maturity (and therefore produce capital gains). The Notice describes this pattern of behavior without qualification and could be read to suggest that the termination payments received are economically a substitute for the payments that would have otherwise occurred pursuant to the terms of the NPC. As a result, it is not entirely clear whether the Notice would cover funds for which tax is not an overriding determinant of trading decisions. For example, a fund might take into account the tax character consequences of the decision to terminate an NPC as one of several trading signals, such that the decision to terminate (or not terminate) an NPC will also be influenced by fundamental investment signals. In addition, if a fund does not have a pattern of terminating NPCs immediately or shortly before the date on which a payment would be made pursuant to the terms of the NPC, the termination payments may not clearly act as an economic substitute for the payment that would otherwise be made pursuant to the terms of the NPC (because the termination results in different economic consequences).

Retroactive Section 988(a)(1)(B) Elections

Taxpayers may elect under section 988(a)(1)(B) to treat a foreign currency contract as producing 60 percent long-term/40 percent short-term capital gain or loss under section 1256 (the “60/40 character rule”). In the absence of such an election, foreign currency contracts produce ordinary gain or loss under section 988. The section 988(a)(1)(B) election must be made by the close of the day on which the contract is entered into. The Notice indicates that certain taxpayers have employed a strategy under which short-dated foreign currency contracts are entered into and closed on the same day and the section 988(a)(1)(B) election is made only for the contracts that produced a gain, such that all losses are

ordinary in character and all gains are subject to the 60/40 character rule. It is not entirely clear if the government views as problematic the degree of hindsight, the programmatic manner in which this strategy has been implemented, or both. For example, if a taxpayer closed transactions a day or several days after entering into the transaction, the taxpayer would not know with certainty whether the election would be advantageous, but such a practice might allow a taxpayer to produce a pattern of capital gain and ordinary deductions.

Straddle Transactions

The Notice describes a foreign currency straddle transaction in which the taxpayer obtains economic exposure to a foreign currency through regulated futures contracts subject to the 60/40 character rule and offsets that exposure through foreign currency contracts that produce ordinary gain or loss under section 988. The taxpayer identifies the offsetting positions as an identified straddle. When the contracts are later terminated, the regulated futures contract is always terminated first. If the regulated futures contract is in a gain position, the taxpayer recognizes capital gain subject to the 60/40 character rule and subsequently recognizes the offsetting loss on the foreign currency contract as an ordinary loss. If the regulated futures contract is in a loss position, the realized loss is capitalized into the foreign currency contract and reduces the ordinary gain (or increases the losses) that would otherwise be realized when the foreign currency contract is closed.

The Notice does not cover all types of transactions commonly employed by “tax-aware” funds and it acknowledges that certain long-standing, well-established techniques may be used to reduce federal income taxes in a manner consistent with the intent of Congress. The Notice gives as an example a “self-indexing strategy” where a taxpayer desiring exposure to a particular financial index comprised of equity securities may invest directly in the underlying securities and may choose to sell the securities that have unrealized losses at year-end and retain securities that have unrealized gain at year-end. This is consistent with previous comments by Treasury officials that conventional “loss harvesting” strategies were not considered abusive.

Potential Governmental Actions

The Notice indicates that Treasury and the IRS are considering issuing additional guidance or taking other action to address the transactions described in the Notice. Such guidance could include regulations, notices, revenue rulings, and other guidance published in the Internal Revenue Bulletin, including the potential identification of a transaction as a transaction of interest or a listed transaction. The appropriate tool may depend to some degree on the transaction in question. In some situations, the government may be able to challenge a transaction under existing law by asserting existing statutory anti-abuse rules or judicial doctrines, as illustrated by the Ruling. In other situations, a challenge under current law may be more difficult, but there may be authority for regulations limiting certain aspects of the identifications and elections used to create tax benefits. However, for some of the transactions, a challenge under existing law may be difficult, the government may lack regulatory authority, and/or the regulatory “fix” may not be readily apparent.

The Notice expresses an intent that any guidance will target specific abusive transactions, will minimize compliance burdens, and will respect market expectations with respect to conventional, long-established tax planning that is consistent with the intent of Congress. While that sentiment is certainly welcomed by taxpayers, the Notice also indicates that future guidance could apply retroactively to transactions that have taken place at the time guidance is issued. Regulation retroactivity is only possible in situations where it is necessary to prevent abuse. It is not clear whether the government considers all the transactions described in the Notice “abusive” or if a court would agree with that position—considering some of the transactions are, at least in their more sympathetic forms—essentially choosing a more tax-efficient means of investment or making an election provided under the relevant statutes and/or regulations in a manner most beneficial to investors.

How KPMG Can Help

KPMG can help fund managers evaluate their existing and contemplated tax-aware investment strategies under current law and advise on best practices for transaction structuring. KPMG can also help investors evaluate various investment options under current law and in light of potential Treasury and IRS actions in the future.

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