

## AN INTRODUCTION TO ETF TAXATION AND 351 CONVERSIONS

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To fully appreciate the potential tax advantages of the ETF structure, investors and advisors need first to understand why ETFs are considered tax efficient. However, many investors who become aware of the ETF’s inherent tax efficiency face another challenge: how can they transition their low-basis investments into the ETF structure tax-efficiently? The answer is a 351 tax-free conversion.

This document addresses the basics of ETF taxation and 351 tax-free conversions for readers new to ETFs. The discussion below is written by Bob Elwood, a practicing tax attorney with extensive experience in ETF taxation and 351 conversions. If you’d like to discuss further, please contact Wes Gray at [wes@etfarchitect.com](mailto:wes@etfarchitect.com).

## AN OVERVIEW OF THE ETF STRUCTURE AND TAX ADVANTAGES

There are numerous nontax and tax advantages to an ETF structure:

### NONTAX ADVANTAGES

- **Transparency:** In most cases, an investor can see what assets an ETF is holding daily, while mutual funds generally only disclose their holdings quarterly. SMAs and private funds vary in that regard but generally do not offer daily transparency.
- **Liquidity:** ETF shares are bought and sold during the day while the markets are open. ETF investors know almost instantaneously how much they paid to buy shares and how much they received after selling. It also means that an investor can exit the fund during the trading day instead of waiting for a redemption to occur at the end of the day after the markets for the fund's underlying assets have closed. Particularly during times of volatility, this can be a considerable benefit over mutual funds; when net asset value is calculated only at the end of each day, and redemptions are processed at that net asset value, then shareholders are subject to the trading activity that follows their exit decision.
- **Trading:** An ETF investor can easily use trading techniques such as limit orders, stop-limit orders, short sales, and buying shares on margin. SMA investors, private fund investors, and mutual fund investors cannot.
- **Cost:** ETFs typically offer lower costs than comparable SMAs, private funds, and mutual funds, which is good news because, generally, the lower the cost of investing in a fund, the higher the expected return for that fund.
- **Fees:** In the ETF wrapper, the advisor's management fee is deducted directly from fund assets and, as a result, is accounted for when calculating an individual investor's gain or loss. This contrasts with an SMA account, where the fee is collected outside the specific investments and cannot be claimed as a tax deduction.
- **Scale:** The ETF model may also help simplify an advisor's operations. In an SMA platform, an advisor must efficiently manage tens, if not thousands, of separate client accounts. This oversight can require significant investment in additional hardware, software, and/or staff to perform such nuanced management. However, suppose an advisor would transition to a handful of strategies offered via an ETF. In that case, they may have more streamlined client reporting, trading systems, portfolio management, and compliance oversight, delivering increased efficiencies.
- **Access to Complex Investments:** Another benefit of scale is that an ETF can more easily access complex instruments that are difficult or impossible to obtain on an SMA platform. For example, certain derivatives, actual foreign securities, private placements, and hedge funds may not easily fit in an SMA setting; however, such investments are routine in the ETF space. They open up potential new investment types to an advisor's clients, and, as a result of the size advantages of the single ETF, they can also make it easier for an advisor to properly maintain a desired target allocation.
- **A Larger Universe of Possible Investors:** Porting a strategy into an ETF wrapper allows additional investors to identify and recognize an advisor's investment offering(s). Serving as an advisor to an ETF traded on a national exchange carries institutional sophistication that can increase brand awareness.

It is important to note that with the increased opportunity for attention comes the potential for increased scrutiny. SMA performance is not available on all major brokerage platforms, updated by the minute. ETF performance is. For some advisors, that kind of openness is an exciting new proposition. For others, it can come as a bit of a shock.

## TAX ADVANTAGES

Perhaps the most significant ETF advantage is a structural one. Generally, holding an ETF in a taxable account will generate a smaller tax liability than if the investor held a similarly structured SMA, private fund, or mutual fund in the same account (other than a tax-advantaged account like an IRA).

Both mutual funds and most ETFs are taxed as regulated investment companies. When an investor buys and holds mutual funds or ETF shares, the investor will owe income tax each year on any dividends received. An investor may also have to pay taxes each year on their share of the mutual fund's or the ETF's net capital gains — even if the mutual fund or ETF has had a negative return and the investor has not sold any shares. That is because the law requires mutual funds and ETFs to distribute any net capital gains on selling portfolio securities to shareholders. Fund shareholders expect that gains and losses will be realized and recognized when a manager implements investment changes in the portfolio, but in the mutual fund these gains are also incurred because of mutual fund flows. When portfolio turnover is high, but flows cause the turnover — dollars going in and out of the fund — the fund shareholders collectively are affected by gains and losses caused by flows instead of those caused by portfolio management concerns. An ETF structure generally has fewer taxable events than in a mutual fund. When mutual fund shareholders redeem shares, the manager must sell securities to raise cash to pay the redemption proceeds. The sale of securities at a gain creates capital gains for the shareholders, including those with an unrealized loss on the overall mutual fund investment.

In contrast, when an individual investor wants to sell ETF shares, he sells them to another investor over the exchange, as he would any stock. No muss, no fuss, no capital gains transaction for the ETF. ETFs are typically more tax efficient than mutual funds because an ETF manager accommodates investment inflows and outflows by creating or redeeming in-kind “creation units,” which are baskets of assets that approximate the entirety of the ETF portfolio. Creation units are managed by authorized participants (APs); as a result, the investor is usually not exposed to capital gains on any individual security in the underlying structure.

When APs redeem shares, the ETF does not typically sell stocks to pay the AP in cash. Rather, the issuer pays the AP in kind delivering the underlying holdings of the ETF itself. No sale means no capital gains because the in-kind redemption is not taxable to the ETF, thanks to Section 852(b)(6) of the Internal Revenue Code of 1986 (the “Code”). But it gets even better: The ETF issuer can pick and choose which shares to give to the AP, meaning the ETF can transfer the shares with the lowest possible tax basis. This reduces the fund's tax burden and ultimately results in higher after-tax returns for investors.

With a basic understanding of the potential benefits of the ETF structure, the next question is how we might get assets from managed accounts into the ETF structure, tax-efficiently.

## IMPORTANT CONSIDERATIONS FOR AN SMA TO ETF 351 CONVERSION

Several logistical factors must be considered before deciding to convert to an ETF. Making sure a plan is in place to tackle these issues can help to ensure the process goes smoothly and allows for the success of the ETF after the conversion is completed.

- **Gaining Client Permission:** Before converting to an ETF, current investors within the SMA will need to provide permission for the conversion. This letter will inform the recipient of an impending action (the conversion) and give them a specified time frame to respond if they object to the conversion.
- **Recordkeeping:** Accurate recordkeeping of the SMA is necessary before converting an SMA into an ETF. Log all positions' cost basis and purchase date in every client account. This process is essential because even though all assets will be contributed in-kind to the authorized participant while being pooled within the ETF, current clients must have ETF shares issued at a cost basis and holding period that reflects their prior investment. In other words, while the conversion itself is not taxable, maintaining accurate records before conversion is essential to ensure the client receives the ETF at the appropriate cost basis and can accurately realize capital gains or losses when they sell ETF shares going forward.
- **Dealing with Custodians and Similar Parties:** Depending on who acts as the present custodian for the securities transferred or if multiple custodians are involved, the in-kind transfers can be time-consuming for the advisor and custodians. Lead time may be required.
- **Sufficient AUM:** Before beginning the conversion process, the advisor should consider whether the strategy has sufficient assets. While converting into an ETF provides more comprehensive access to the strategy, it is improbable to draw in millions in new money overnight. One thing to consider is that various platforms often require a minimum asset value to include strategies. While each platform will have specific guidelines, \$25-\$50 million is usually a good benchmark when considering what asset minimum might be necessary for approval. However, it could take an even higher asset value for the ETF to break even on costs. While the exact amount will vary depending on the expense ratio of the ETF itself, it is estimated that at least \$40-45 million in assets under management is necessary to reach this breakeven point.

## HOW DOES AN SMA TO ETF 351 CONVERSION WORK?

The individual SMA investors (collectively, the "Transferors") will contribute securities to a newly formed ETF (the "ETF") in exchange for shares of the ETF (the "Proposed Transaction").

Under Code Section 351(a), no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in "control" (as defined in Section 368(c)) of the corporation.

There are primarily four things to keep in mind as you consider the Proposed Transaction: special rules; diversification; control; and the need to have a plan.

## 1) SPECIAL RULES FOR TRANSFERS TO INVESTMENT COMPANIES

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Section 351(e) provides that a transfer to an investment company (such as the ETF in the Proposed Transaction) does not qualify for this nonrecognition treatment. To make matters worse, Section 351(e)(1)(B)(iv) states that any interest in a regulated investment company (such as the ETF) is treated as an investment company. Fortunately, for our purposes, Section 351(e) also provides that the IRS may prescribe regulations permitting non-taxable transfers to investment companies.

Under Treas. Reg. Section 1.351-1(c)(6), portfolios of stocks and securities that are already diversified are not covered by Section 351(e) and can be transferred to an investment company under Section 351(a) without recognition of taxable gain or loss. The definition of what constitutes a portfolio being already diversified is discussed below. As noted below, since the expectation is that the Transferors will satisfy the diversification test, the Proposed Transaction should qualify for the unique requirements applicable to transfers to an investment company.

## 2) DIVERSIFIED ASSETS

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The idea behind this requirement is that the IRS does not want parties to be able to make non-taxable transfers to an investment company unless the portfolio being transferred to the ETF is already reasonably well-diversified.

Specifically:

- No more than 25% of the value of the total assets of the portfolio of the securities each Transferor will be contributing can be the stock and securities of any one issuer. In other words, the biggest position cannot be more than 25% of the total portfolio being contributed.
- Not more than 50% of the value of such total assets is invested in the stock and securities of five or fewer issuers. Practically, each Transferor would need 11 or more positions to transfer. However, registered investment companies (“RIC”), have slightly different rules. Specifically, 5% and higher positions can’t collectively be more than 50% of the portfolio’s net asset value. We will need to consider the RIC rules when we are facilitating a 351 because the managed accounts will transform into an ETF after conversion.
- In determining total assets, you exclude cash and cash items (including receivables), Government securities, and assets acquired (through incurring indebtedness or otherwise) to meet the requirements of satisfying the 25% or 50% test.
- For purposes of these rules, all members of an affiliated group of corporations are treated as one issuer. This usually only comes up occasionally in connection with things like tracking stock.
- For purposes of these rules, if a Transferor holds stock in a regulated investment company, a real estate investment trust, or an investment company that meets specific requirements, then the Transferor is treated as having the proportionate share of the assets held by such company or trust, i.e., “look-through” treatment.

## 3) “CONTROL”

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A transfer of assets by one or more parties solely in exchange for the stock of a registered investment company (the ETF in our case) does not give rise to the recognition of gain or loss if,

immediately after the transfer, that party or those parties are in “control” of the RIC. Control for this purpose is the ownership of stock possessing 80% of the voting power of all shares of voting stock and 80% of the number of shares of all nonvoting stock classes. No historical connection or relationship must exist among the transferors to be treated as a “group” of transferors whose interests can be aggregated to determine whether the required 80% control exists.

The individual SMA investors constitute a control group and should have well over 80% of the vote and value of the ETF upon its launch. Note that transfers of cash by the public and transfers of assets by an authorized participant will not interfere with the tax-free nature of the transfer of assets in kind. Accordingly, we should have no trouble with the “control” requirement.

#### 4) A WRITTEN PLAN

You will also need a written plan for the Proposed Transaction.

#### WHAT ARE THE TAX CONSEQUENCES OF SMAs THAT CONVERT INTO AN ETF?

If you’ve made it this far, congratulations; you are a bonified geek and probably fit in well with the culture at Alpha Architect. Post ETF conversion, how are taxes sorted out? We have several aspects to consider:

#### TAX CONSEQUENCES TO THE ETF

The ETF will have no taxable gain or loss. The ETF will have a carryover basis and carryover holding period in the assets transferred. For example, if the SMA contributions have 0 basis in a portfolio of assets, the ETF will have a 0 basis in the same assets.

#### TAX CONSEQUENCES TO THE INVESTORS

The Investors will have no taxable gain or loss on the transaction. The Investors will have a carryover basis and carryover holding period in the ETF shares corresponding to the basis and holding period of the transferred assets.

#### TAX OPINION

A tax opinion is typically provided to give clients and constituents comfort in the transaction.

#### SUMMARY

This piece outlines the high-level benefits of the ETF structure, which boils down to market access, tax efficiency, and transparency. It covers the considerations for a 351 tax-free conversion and the mechanics and tax consequences of a 351 conversion.

Of course, this piece merely introduces the critical components of 351 transactions. The devil is always in the details, and the 351-conversion tool is not always the best way to solve a particular problem. To learn more, or if you have a question for me, please contact [wes@etfarchitect.com](mailto:wes@etfarchitect.com).