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ETF's Secret Sauce

ETFs (Exchange Traded Funds) are known to be more tax friendly than open end mutual funds even though both are governed and taxed as Regulated Investment Companies (RICs).

The difference is that ETFs routinely use IRC Section 852(b)6 to purge portfolios of holdings with big unrealized gains while mutual funds seldom utilize this powerful tool although they could.

Let’s assume a fund (ETF, closed-end fund or mutual fund) has a position in XYZ that the fund bought for $100 many years ago. The XYZ position is now worth $1000; with $900 of unrealized capital gain. If the fund sells the XYZ, the fund realizes a $900 gain that will be passed on to shareholders. If instead the fund gave the $1000 of XYZ to a redeeming shareholder instead of redeeming the departing shareholder with $1000 in cash, NO GAIN would be realized by the fund under IRC Section 852(b)6. And this has no negative effects to the redeeming shareholder who would have the same amount of gain or loss as if they received cash (assuming the stock is sold immediately when received for the same value). Thus the fund has exited the shares while triggering no gain at the fund level nor increased the tax at the fund holder level.

As you know, ETFs are traded throughout the day and at the end of the day the “authorized” market makers can redeem the ETFs for a slice of the fund’s portfolio. This redemption in kind can be used by the fund to rid itself of low cost basis shares without any negative tax consequence. If an indexed fund bought shares before the bull market started it is most likely sitting on shares that it recently bought with small gains or losses and shares bought long ago at prices much lower than today’s value. The fund/ETF is allowed to use “specific lot identification” to declare that the shares they are distributing are the shares bought years ago rather than being forced to use shares recently bought as would be necessary under a last in first out methodology. Of course if there are shares with unrealized losses those would not be distributed since the fund will forfeit any tax benefit from the loss by distributing.

All mutual funds have in their documents the ability to make redemptions in kind rather than selling portfolio holdings and triggering gain. This ability has traditionally been reserved in case the fund must meet a very large redemption or that the underlying shares are so illiquid it would be best for all if the shares were distributed rather than sold. This is used very infrequently because the redemption in kind has always been thought of as a last resort. The WSJ recently reported that the Sequoia Fund surprised some redeeming shareholders by redeeming in kind. The president of the fund David Pope rebuffed any criticism by pointing out the tax benefit to the continuing shareholders from redeeming in kind versus selling; "We redeem with shares to benefit our continuing shareholders, who might otherwise pay capital-gains taxes on the sale of appreciated stock that might be required for redemptions. By redeeming in kind, our 20,000 continuing Sequoia shareholders will pay lower capital-gains taxes in the future. "

Innovations that Exploit the Difference

As you can see, the redemption mechanism built into ETFs can make those ETFs much more tax friendly than an open end indexed fund run side by side by the same manager.

Vanguard

Vanguard's ETFs are setup differently than everyone else's ETFs. The Vanguard ETFs are not stand alone ETFs, the Vanguard ETFs are just another share class of the Vanguard open end index mutual fund. This becomes a very important difference because redeeming Vanguard ETF holders can leave with low basis shares owned by the open end fund. Thus the Vanguard ETFs become a dialysis machine ridding the mutual fund portfolio of those pesky shares bought long ago at much lower prices. Vanguard has a patent on this setup that will protect the idea for another few years and then I'd expect everyone to rejigger their offerings to create a system as favorable as Vanguard's is today.

Eaton Vance

Eaton Vance recently patented NextShares. NextShares are ETMFs (Exchange Traded Mutual Funds) that are something like a crossover between an ETF and an open-ended mutual fund. NextShares will redeem shareholders in kind through Section 852)(b)6. Because of this NextShares are promised to be more tax efficient than a "regular" mutual fund run in the exact same manner. Eaton Vance reports that they have a dozen other fund complexes that have indicated their intent to offer NextShares Funds by filing exemptive applications with the SEC and entering into preliminary agreements with NextShares Solutions LLC .

Reflow

Reflow (started by Gordon Getty) will eventually either wind up leveling the tax playing field between ETFs and mutual funds OR become the "straw that breaks the camel's back" that forces the government to remove Section 852(b)6 because it is losing too much revenue for the Treasury. Reflow offers to invest cash in a fund that needs to meet redemptions and then leave the fund with a basket of securities. As Alan Siegerman, COO of Reflow, said "the redemption in kind service allows a mutual fund to experience some of the advantages of an exchange-traded fund in that in-kind exchanges typically have a more favorable tax treatment than purchases and redemptions done directly with the fund."

It is obvious that the opportunity to manage taxes within a fund is becoming available to more types of funds than just traditional indexed ETFs; stay tuned.