The Secret Sauce of Exchange-Traded Funds

By Robert N. Gordon

Exchange-traded funds (ETFs) are known to be more tax friendly than open-end mutual funds even though both are governed and taxed exactly the same, 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 and mutual funds seldom utilize this powerful tool. Now some observers are saying that ETFs are exploiting a loophole to avoid taxes that must be closed.[1]

Although many ETFs reduce their gains realizations through redemptions in kind, others aren't very tax-efficient at all and others aren't even funds.[2] Don't assume that all ETFs possess the favorable characteristic of the low turnover indexed Standard & Poor's Depositary Receipts (SPDR).[3] If the underlying trading strategies of the ETF do not allow for any tax efficiency, don't expect the ETF wrapper to magically transform the ETF into a tax-friendly investment.

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How Tax-Efficient ETFs Accomplish Their Goal

Highly tax-efficient ETFs gain their tax advantage by using a combination of a fairly passive investment strategy and Internal Revenue Code (IRC) Section 852(b)6. This code section lets funds redeem shareholders with portfolio shares without triggering a gain/taxable event at the fund level. ETFs, open-end mutual funds, and closed-end funds are all RICs governed by the Investment Company Act of 1940. Section 2(a)32 of the act allows for a fund to redeem shareholders with portfolio shares instead of cash. This liberty was afforded so that if a fund had a stampede of redemption requests it could lessen the tax and economic impact by distributing the portfolio holdings instead of selling them into the market. The U.S. Supreme Court's 1935 decision in *General Utilities & Operating Co. v. Helvering* allowed all corporations (RICs included) to distribute property to shareholders without triggering a taxable event to the corporation. The 1986 Tax Reform Act repealed the *General Utilities* doctrine for all corporations, but funds were specifically exempted from the repeal and allowed to continue to benefit from non-gain recognition, leading to IRC Section 852(b)6, all of which predates the first ETF. Those who see this as a tax shelter are now calling for reform of this code section.

Disappearing Gains

Let's assume a fund (an 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 $1,000; it has $900 of unrealized capital gain. If the fund sells the XYZ position, it realizes a $900 gain that will be passed on to shareholders. If instead the fund gave the $1,000 of XYZ to a redeeming shareholder instead of redeeming the departing shareholder with $1,000 in cash, the fund would realize no gain under IRC Section 852(b)6. This event would have no negative effects to the redeeming shareholder, who would have the same amount of gain or loss as if the redemption had been transacted with cash (assuming the stock is sold upon receipt for the same value). Thus, the fund has exited the shares and has neither triggered any gain at the fund level nor increased the tax at the fund-holder level.

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. The fund can use this redemption in-kind 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 that it bought long ago at prices much lower than today's value. The fund/ETF is allowed to use "specific lot identification" to juice up the amount of loss while minimizing the realization of gain. Through lot identification the fund can instruct that the shares it is distributing are the shares bought years ago at lower prices rather than being forced to use the basis of shares recently bought, which would be necessary under a last-in first-out methodology. Any shares with unrealized losses would be sold and not distributed because the fund would forfeit any tax benefit from the loss by distributing.

Why Don't Mutual Funds Use 852(b)6?

All mutual funds have the ability to make redemptions in-kind rather than selling

Table 1: The Vanguard Advantage

	ETF (RIC)	No-Load Open End Index Fund	Vanguard Open-End Index Fund	Vanguard ETF	ETMF
Commission on sale/purchase	yes, disadvantage	no, advantage	no, advantage	yes, disadvantage	yes, disadvantage
Bid/Ask Spread	yes, disadvantage	no, advantage	no, advantage	yes, disadvantage	yes, disadvantage
Deviation from NAV	yes, disadvantage	no, advantage	no, advantage	yes, disadvantage	no**, advantage
Can sell at market intraday	yes, advantage	no, disadvantage	no*, disadvantage	yes, advantage	no***, disadvantage
Utilizes IRC Section 852(b)6	yes, advantage	no, disadvantage	yes, advantage	yes, advantage	yes, advantage
ADVANTAGES	**2**	**3**	**4**	**2**	**2**

*could short the ETF to achieve this advantage

**trades intraday at a % of closing net asset value (NAV)

***intraday sellers receive % of closing NAV not spot NAV

portfolio holdings and triggering gain. This ability has traditionally been reserved in case the fund must meet a very large redemption or the underlying shares are so illiquid it would be best for all if the shares were distributed rather than sold. The 1940 Act's Section 2(a)32 allows for redemptions in-kind to alleviate exactly this situation. But mutual funds have used redemption in-kind very infrequently; they always have treated it as an option of last resort. A few fund stalwarts have gone forward willing to combat any shareholder concerns. The Sequoia Fund has routinely redeemed in-kind since 1998.[4] Sequoia President David Poppe has pointed 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."[5] It should be noted that Sequoia, rather than redeeming a proportionate slice of its portfolio, has instead handpicked shares with very low cost basis for distribution.

Vanguard Exploits the Difference

The redemption mechanism built into ETFs can make those ETFs much more tax friendly than an open-end index fund run by the same manager—unless that manager has access to Vanguard's patented innovation in this area.

Vanguard's ETFs are set up differently than everyone else's ETFs. Vanguard ETFs are not stand-alone ETFs, they 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 the fund taking with them low cost-basis shares purchased by either the open-end fund or the ETF. Thus, the Vanguard ETFs become a dialysis mechanism, ridding the mutual fund portfolio of those pesky shares bought long ago at much lower prices. This should make the Vanguard open-end fund more tax-efficient than any other open-end fund that does not avail itself of the benefits of Section 852(b)6. Vanguard has a patent on this setup that will protect the idea for another few years.[6] After the patent expires, I expect everyone to rejigger their offerings to create a system as favorable as Vanguard's is today.

Table 1 compares the two Vanguard share classes and illustrates the pluses and minuses of each structure since both would produce the same tax results. The long-term investor should buy the no-load fund that will be helped out by redeeming short-term traders that need to be able to trade at market prices during the day.

Additional Innovations Push the Envelope

ReFlow

Gordon Getty's innovative ReFlow could level the tax playing field eventually between ETFs and mutual funds. 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, chief operating officer 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." [7]

Eaton Vance

Eaton Vance patented NextShares, which are exchange-traded mutual funds (ETMFs), which are a crossover between an ETF and an open-end mutual fund. NextShares will redeem shareholders in-kind through Section 852(b)6, so NextShares are promised to be more tax-efficient than a regular mutual fund run in exactly the same manner. Eaton Vance reports that as of December 31, 2016, 15 investment advisors had indicated their intent to offer NextShares. These stand-alone funds are a clever innovation that exists to allow actively managed strategies in ETF form that can exploit Section 852(b)6 and thus level the playing field between actively and passively managed funds.

Disproportionate Redemptions

We are used to indexed ETFs that redeem a proportionate slice of their portfolios to redeeming holders. Now a few actively managed vehicles, such as Sequoia, noted

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above, instead will deliver whatever they'd like to redeem. Indeed, if a fund could redeem by cherry picking shares to sell, active managers could best deal with redemptions—selling exactly what they might have sold if in an open-end format. Non-proportionate redemptions can make an ETF more efficient than one that only distributes a slice of the portfolio. But it should be noted that IRS private rulings received by some closed-end funds dictated that redemptions in-kind should be proportionate, both as a slice of the portfolio and tax cost-basis.[8]

We expect that even if the debate gathers steam, any changes to Section 852(b)6 will be drawn out. ETFs come in many shapes and sizes; advisors should make sure that the ETFs they choose have the desired characteristics to ensure that clients get the tax efficiency they desire.

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Endnotes

1. See Lee Sheppard, "ETFs as Tax Shelters," *TaxNotes* (March 14, 2011), available to subscribers at http://www.taxnotes.com/tax-notes-today/financial-instruments-tax-issues/news-analysis-etfs-tax-shelters/2011/03/14/4696016; Stephen Kane and Christopher Cohen, "Loopholes and Financial Innovation," *International Business & Economics Research Journal* 3, no. 7: 45–58; Steven Hodaszy, "Tax-Efficient Structure or Tax Shelter? Curbing ETFs' Use of Section 852(b)(6) for Tax Avoidance," *The Tax Lawyer* 8, no. 2 (winter 2017): 537–607.
2. United States Oil Fund® LP (USO) and United States Natural Gas Fund® LP (UNG) are commodity pool limited partnerships trading futures; SPDR Gold Shares (GLD) is a grantor trust and most ETFs holding master limited partnerships flunk the test to be a fund and are taxable as corporations.
3. See Robert N. Gordon, "When ETFs Pass Along Gains," *InvestmentNews* (February 11, 2008), http://www.investmentnews.com/article/20080211/REG/119620362/when-etfs-pass-along-gains.
4. See Karen Damato, "Redemptions in Kind' Become Effective for Tax Management," *Wall Street Journal* (March 10, 1999), https://www.wsj.com/articles/SB921028092685519084.
5. See David M. Poppe, "Sequoia's Redemption with Securities Is Tax Efficient," Letter to the Editor, *Wall Street Journal* (April 13, 2016), https://www.wsj.com/articles/sequoias-redemption-with-securities-is-tax-efficient-1460583731.
6. Vanguard originally filed a utility patent (6,879,964) in March 2001. Vanguard spokesman was quoted that the patent expired in 2023. See Ari I. Weinberg, "Firms Try Varied Designs to Add ETFs," *Wall Street Journal* (February 3, 2013), https://www.wsj.com/articles/SB10001424127887324624404578255940811549604.
7. See "ReFlow Looks to Expand Redemption In-Kind Service," *Operations Management* (April 2,2007), https://business.highbeam.com/1674/article-1G1-162774932/reflow-looks-expand-redemption-kind-service.
8. Private Letter Ruling 2004-14-043 (October 17, 2003); Private Letter Ruling 2000-23-021 (June 9, 2000).