The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

Letter from the Investment Company Institute

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Electronically submitted via www.regulations.gov

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Internal Revenue Service

Re: Notice 2026-62 & Rev. Rul. 2026-20 "Guidance and Other Actions Being Considered Regarding Certain Potentially Abusive Investment Fund Strategies Involving Financial Products"

The Investment Company Institute (ICI)[1] submits these comments on Notice 2026-62 (the "Notice") and Revenue Ruling 2026-20 (the "Revenue Ruling"), which address certain section 351 conversions and uses of redemptions in kind. ICI's members include more than four thousand U.S. exchange-traded funds (ETFs), the vast majority of which are regulated investment companies (RICs) registered under the Investment Company Act of 1940 (the "1940 Act"). While ETFs engaging in transactions described in the guidance are a small fraction of these ETFs, the guidance has drawn significant interest from the ETF industry.

If Treasury and IRS issue additional guidance, ICI recommends:

- **Narrow scoping**: any additional guidance should be narrowly tailored to the transactions and policy concerns identified in the Notice and Revenue Ruling (collectively, the "guidance"), to distinguish transactions described in the guidance from ordinary portfolio management. ICI members shared concerns about the potential disruption caused by differing interpretations of the guidance, or broader application of the guidance to redemptions in kind or 351 conversions undertaken for ordinary business reasons.
- **Prospective guidance**: additional guidance should apply prospectively whenever possible and consistent with Treasury and IRS's objective, with appropriate transition and remediation relief if any provisions apply retroactively.
- **Clarification of Terms in Revenue Ruling 2026-20:** If additional guidance is issued, it should clarify important undefined concepts including "plan," "shortly thereafter,"

[1] The Investment Company Institute (ICI) is the leading voice of the asset management industry serving individual investors. ICI represents mutual funds, exchange-traded funds (ETFs), and closed-end funds with 125 million shareholders in the United States. ICI also represents investment advisers to collective investment trusts (CITs) and separately managed accounts (SMAs) serving tens of millions of individual investors. ICI members include other key participants in the asset management industry, including CIT trust companies and service providers to funds.

"investment thesis," and "materially different," focusing on the parties' intent at the time of conversion, and also address the deemed sale consideration, valuation, and related tax consequences of the deemed sale holding.

- **Narrowly define the three other redemption-in-kind strategies:** Define the box spread, record date, and RIC income test strategies narrowly, with intent as the guiding principle, so that guidance does not disrupt options use, funds of funds, or inadvertently acquired assets.
- **Differentiate the "tax-aware strategies" from other derivatives strategies:** Distinguish the strategies described in the Notice from the routine use of identified straddles, section 988(a)(1)(B) elections, and notional principal contracts for non-tax investment purposes.

I. General Comments

As RICs and regulated '40 Act funds, ETFs and mutual funds have substantial internal risk and compliance oversight and are subject to federal regulation from the Securities and Exchange Commission (SEC), Treasury, and IRS. These regulated funds are managed by fiduciaries and audited by both internal and independent auditors. Strong, consistent compliance with all applicable laws and regulations, including tax law and guidance, is critical to their viability and accountability to shareholders. Accordingly, we support guidance that clarifies the application of tax law and regulations, providing our members with the tax certainty required to maintain strong tax compliance. Our members have expressed support for clear guidelines that provide a level playing field for all ETFs and discourage competition based only on tolerance for tax risk.

The guidance is intended to provide this clarification, and we appreciate the opportunity to comment and raise issues for consideration in future guidance. The guidance is intended to address specific "strategies that purport to produce tax results that may be inconsistent with the purpose and proper application of the relevant federal tax rules."[2] We support limiting the scope of the guidance to these specific concerns and strategies and encourage Treasury and IRS to narrowly tailor any future guidance to avoid potential market disruption. The guidance generally strikes this balance, but leaves some uncertainty in scope and interpretation, which we will address in more specific comments below.

We are glad to see that the guidance does not address section 351 conversions or redemptions in kind generally, which are supported by existing law and regulations. The guidance "will respect market expectations with respect to conventional, long-established tax planning that is consistent with the intent of Congress."[3] We recommend that any additional guidance addressing section 351 conversions should remain confined to that context.

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[2] Notice 2026-62, Section 1.

[3] Notice 2026-62, Section 1.

Guidance addressing the other three ETF-related strategies identified in the Notice should target the specific tax-character or qualifying-income concerns identified in the Notice without broadly restricting redemptions in kind.

The Notice indicates that Treasury and IRS are considering additional future guidance on the transactions described. We recommend that additional guidance apply prospectively to minimize disruption to existing funds and shareholders. If any guidance applies retroactively, it should preserve access to otherwise available statutory relief, such as RIC cure provisions, deficiency dividends,[4] or qualifying income cure provisions,[5] and provide appropriate transition and fund-level remediation mechanisms to minimize the need for amended shareholder reporting and returns. We generally do not recommend any specific form of guidance over others, but we recommend that future guidance solicit and consider additional comments. We also note that certain guidance, such as transaction of interest designations or retroactive guidance, could cause significant disruption in the ETF industry, particularly if drafted broadly or ambiguously.

We appreciate Treasury's public comments at a July Wall Street Tax Association panel discussion, which outlined the same strategies described in the Notice, and likewise appreciate that the Notice does not vary much from these comments. These remarks were effective in putting the ETF industry on notice of Treasury's concerns, and consequently, the written guidance was not surprising to much of the industry. We anticipate that Treasury and IRS expect to issue additional guidance soon, and we welcome clear, tailored guidance.

II. New ETFs Formed by Section 351 Conversions

Prior ICI discussions with Treasury about section 351 conversions to ETFs were very helpful for the ETF industry. We learned more about Treasury's interest and potential concerns, and shared information about how and why some of our members are planning and launching new ETFs through conversion transactions intended to qualify for nonrecognition treatment under section 351. Our comments will not repeat all prior comments, but will raise some points relevant to the guidance, beginning with some historical background on the regulated fund industry's reliance on section 351 when forming new RICs.

A. Historical Application of Section 351 to Regulated Investment Companies

Asset managers have been contributing assets to form new RICs in transactions intended to qualify for nonrecognition treatment for decades. Until recently, most new RICs were funded with cash, so-called "seed money" from the asset manager, and the application of section 351 was neither in doubt nor particularly relevant, given that the contributed assets were mostly cash and the asset manager was typically the fund's controlling shareholder during the startup

[4] § 860.

[5] § 851(i).

phase. Some RICs were funded with portfolios of securities, generally from another RIC, or from a single institutional investor, so the diversification limits applicable to multiple investors were rarely constraining for these earlier in-kind 351 conversions.

B. Recent History of Section 351 Conversions Funded with Securities

Over the last four years, many ETFs[6] have been formed by one or more individuals with large portfolios of securities,[7] in transactions intended to qualify for nonrecognition treatment under section 351. While the founding investors certainly consider the tax deferral benefits of nonrecognition under section 351, the ETF structure brings many other non-tax benefits for these investors, including:

- Lower fees typically associated with greater scale from pooling assets from multiple investors
- Regulatory and fiduciary protections for ETFs and their shareholders[8]
- Reduced trading costs and frictions from ETF transactions in kind with authorized participants (APs)
- Professional, full-time portfolio management from a designated portfolio manager
- Liquidity, custody, and collateral benefits of holding a single diversified exchange-traded asset instead of a large separately managed portfolio of tens or hundreds of different securities (estate planning, gifting, borrowing / collateral)
- Diversification, within section 1.351-1(c)(6) diversification limits. We note the important and meaningful distinction between:
    - diversification occurring <u>when</u> the ETF is formed, resulting from multiple transferors of non-identical securities, which is clearly contemplated by section 1.351-1(c)(6), and
    - diversification occurring <u>after</u> the ETF is formed by means of portfolio turnover through in-kind transactions.

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[6] We're not aware of any definitive source of data on ETFs formed by 351 conversions; some estimates have exceeded 100. https://section351etf.com/etf-conversions-database/. Of those, less than half are ICI members.

[7] Anecdotal information suggests that new ETFs require approximately $40 million to $100 million of assets at inception to become viable funds from inception. These assets can be raised from a single high-net-worth investor, or from many investors with smaller portfolios.

[8] These include the Securities Act of 1933, which requires registration of the fund's shares and the delivery of a prospectus; the Securities Exchange Act of 1934, which regulates the trading, purchase and sale of fund shares; the Investment Advisers Act of 1940, which regulates the conduct of fund investment advisers; the Investment Company Act of 1940, which requires all funds to register with the SEC and to meet certain operating standards, bring fiduciary protections, require independent directors, disclosures, liquidity, valuation, restrictions on affiliated transactions, custody, and leverage limits, among others.

ETFs formed by 351 conversions have meaningful non-tax benefits for the founding investors,[9] and we appreciate that the guidance does not broadly target all RICs formed by 351 conversions. The Notice states that it "does not address, and expresses no view regarding, transactions in which a § 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)."[10] We appreciate this acknowledgment and encourage Treasury and IRS not to foreclose all section 351 conversions to RICs, and to limit any guidance in the context of section 351 conversions exclusively to 351 conversions described in the Revenue Ruling or the Notice, rather than extending it to all ETFs.[11] We also note that many closed-end funds are formed by 351 conversions to RICs. These closed-end funds typically start as partnerships, gather sufficient assets, and then convert to RICs by contributing their securities in a transaction intended to qualify for nonrecognition under section 351.

C. 351 Conversions Featuring Planned Portfolio Turnover – Rev. Rul. 2026-20

The Revenue Ruling recharacterizes certain contributions of securities to an ETF in a transaction intended to qualify for nonrecognition treatment under section 351 where, as part of a common "plan," those securities are distributed in a redemption in-kind transaction and the resulting portfolio is consistent with the ETF's "investment thesis" and "materially different" from the portfolio transferred by the investor. The Revenue Ruling does not define the terms "plan," "materially different," "shortly thereafter," or "investment thesis," and does not describe factors relevant to the analysis of those terms, which leaves some questions about the intended scope and interpretation. Our comments will focus primarily on these scoping questions that present some uncertainty and have led to inconsistent interpretations among tax professionals. We agree with that the parties' intent at the time of the conversion is the most relevant consideration and should be the guiding principle in determining whether the Revenue Ruling applies.

1. Plan

The Revenue Ruling does not define or describe what constitutes a plan to redeem securities contributed to the RIC, and the term does not appear in the statutory text of section 351(e). We support the Revenue Ruling's focus on intent without providing a rigid or formulaic definition of

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[9] While most, if not all, recent section 351 conversions have been ETFs (and certain other tax-aware planning strategies) the same non-tax benefits described above are generally also applicable to other RICs, such as mutual funds.

[10] Notice 2026-62 Section 2.02.

[11] For example, by proposing to remove § 1.351-1(c)(6).

a “plan” or an exclusive or inclusive list of circumstances in which a “plan” will be deemed to exist. If additional guidance on a plan is contemplated, we recommend that it distinguish between a predetermined disposition of contributed securities and routine portfolio turnover in the course of running an actively managed ETF. Post-conversion redemptions and creations, standing alone, should not establish that a plan existed at the time of contribution. The analysis should consider contemporaneous evidence of the parties’ intent and the circumstances prompting subsequent transactions.

Existing guidance on a “plan” under other provisions of subchapter C and case law could be applied in this context. For example, the rules for corporate mergers could prove useful in determining what constitutes a plan for purposes of section 351, or the “plan” guidance provided in Treas. Reg. section 1.355-7(b). While a detailed analysis of the subchapter C concept of a “plan” is beyond the scope and timing of our comments, reliance on existing subchapter C concepts and case law seems reasonable.

The Notice does not address situations where contributed assets 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).”[12] We appreciate and support this distinction in the Notice. Many ETFs will likely infer that redemptions in kind in response to a substantial change in circumstances arising after the conversion will not be deemed to have been part of a plan described in the Revenue Ruling, if the ETF had otherwise intended and expected to retain those securities.

2. Timing Considerations – Shortly Thereafter

Both the Notice and the Revenue Ruling include “shortly thereafter” phrasing suggesting that timing may be relevant in this analysis, although the wording differs slightly.[13] We recommend clarification of the relevance of the time between transactions, and more specifically, whether “shortly thereafter” refers back to the formation of the RIC, or the creation unit preceding the redemption in kind, or both. In some cases, the sequence of ETF creation and redemption transactions is reversed, so that the redemption in kind precedes the creation unit. In these cases, we presume the Revenue Ruling would still apply if the redemption in-kind was part of the plan.

3. Consistency with Investment Thesis & Materially Different Portfolios

[12] Notice 2026-62 Section 2.02.

[13] In the Notice, “shortly thereafter” refers to the time elapsed between the contribution by investors and the redemption in kind. In the Revenue Ruling, “shortly thereafter” could be interpreted to relate back to either the contribution by investors, or to the creation unit of ETF shares issued to the AP in exchange for securities, in which case the time elapsed between the creation and redemption is relevant.

The Revenue Ruling refers to the consistency of securities with the fund's investment thesis, and refers to a materially different portfolio post-redemption in kind, but does not define these concepts, leaving some ambiguity and differing interpretations of intended scope. We support some amount of planned redemptions in-kind that will not implicate the Revenue Ruling, for ease of administration and to allow for ETF sponsors to deal with small differences between contributed and desired portfolios through conventional means. If additional guidance is contemplated, we recommend clarification of these terms to ensure consistent compliance and create a level playing field for all asset managers, discouraging competition based on tolerance for tax risk.

i. Consistent securities

The Revenue Ruling does not indicate whether the contributed securities were (or were not) consistent with the fund's investment thesis, or whether inconsistency is a threshold requirement for the Revenue Ruling to apply. The Notice, however, states that "some or all of the securities in the transferred portfolio do not align with the ETF's contemplated securities portfolio or investment thesis following the completion of the planned transactions, or the transferred portfolio may have an overconcentration of one or more securities compared to the ETF's contemplated securities portfolio following the completion of the planned transactions." The Notice indicates that at least some securities transferred to the ETF were not consistent with the fund's intended investment thesis or portfolio composition, while the Revenue Ruling is less clear about whether inconsistency is a required condition or not. The Notice implies two comparisons for consistency, between: (1) the securities contributed to the ETF by investors, and the ETF's contemplated securities portfolio, and (2) the concentration of securities contributed to the ETF by investors, and the concentration of securities in the ETF's contemplated securities portfolio. The Revenue Ruling itself does not explicitly require this comparison, leaving some uncertainty about whether an analysis of consistency is required, or not.

ii. Investment Thesis

The answer depends partly on the intended scope of an "investment thesis". The term is not defined and could be interpreted broadly or narrowly.

We note three similar concepts in securities law: a fund's investment objective, principal investment strategy, and the SEC names rule.

A fund's investment objective is typically very broad, often describing how the fund intends to generate investment returns, such as by capital appreciation, or by generating income, or it may describe the index that the fund intends to track.[14] A fund's principal investment strategy

[14] See Form N-1A instructions, Item 9 Investment Objectives, Principal Investment Strategies, Related Risks, and Disclosure of Portfolio Holdings.

is more specific, requiring the fund to describe "any policy, practice, or technique used by the Fund to achieve its investment objectives."[15] Additionally, a fund often discloses in its statement of additional information that it may invest in securities that are not described in the fund's principal investment objective.[16] The SEC names rule requires a fund's investments to be consistent with the fund's name, requiring funds with names suggesting a specific asset, or sector, or geographic location, for example, to invest at least 80% of their assets in such assets, sectors, and locations.[17] As an example, a fund called the Large Cap Equity ETF may disclose:

- "The Fund's investment objective is to generate total returns from capital appreciation and dividend income by investing in the stock of large publicly traded companies."
- "The Fund's principal investment strategy is to invest in stocks issued by large U.S. companies with market capitalizations over $15 billion that are included in the XYZ Large Cap Equity Index."
- The SEC names rule requires the fund to invest at least 80% of its assets in stocks of large companies.

These concepts may prove useful when assessing a fund's investment thesis, but do not provide clear objective standards.

"The fund seeks investment results that correspond generally to the performance, before fees and expenses, of the [index name removed]."

"The Fund's investment objective is to seek total return. Total return consists of current income and capital appreciation."

"The fund strives for the balanced accomplishment of three objectives: current income, growth of capital and conservation of principal."

"The [ETF name removed] seeks to provide long-term total returns."

[15] Form N-1A instructions. "Whether a particular strategy, including a strategy to invest in a particular type of security, is a principal investment strategy depends on the strategy's anticipated importance in achieving the Fund's investment objectives, and how the strategy affects the Fund's potential risks and returns. In determining what is a principal investment strategy, consider, among other things, the amount of the Fund's assets expected to be committed to the strategy, the amount of the Fund's assets expected to be placed at risk by the strategy, and the likelihood of the Fund's losing some or all of those assets from implementing the strategy."

For example, here is the strategy principal investment strategy from a Form N-1A, edited only to remove identifying information. "[ETF name removed] is a market-capitalization weighted index, subject to caps on the weighting of individual companies, that is designed to track companies that support critical emerging technologies across the U.S. and its allies."

[16] Form N-1A instructions. "Disclose, if applicable, that the Fund may, from time to time, take temporary defensive positions that are inconsistent with the Fund's principal investment strategies in attempting to respond to adverse market, economic, political, or other conditions. Also disclose the effect of taking such a temporary defensive position (e.g., that the Fund may not achieve its investment objective).

[17] See 17 C.F.R. § 270.35d-1.

As an example of differing interpretations of an "investment thesis" in the Revenue Ruling, we note that a law professor was recently cited as indicating that ETFs formed by 351 conversions are drafting very broad investment objectives that allow virtually any contributed security to fit the objective, thereby permitting the ETF to "invest in anything" and to be able to say that "anything that gets contributed is certainly part of, or consistent with, [its] investment thesis."[18] Under this interpretation, all "consistent" securities contributed can be redeemed in kind shortly after contribution because the Notice does not apply. We do not interpret the Revenue Ruling this way, but are concerned that differing interpretations will create an unlevel playing field that was likely not intended.

A fund's investment thesis also may be relevant for considering the presence or absence of a plan. For example, active funds generally have significant portfolio turnover each year, much more than a typical passive (index) fund. A portfolio manager of an active RIC is expected to closely monitor and assess the fund's portfolio, and adjust the portfolio if required or merited by the fund's investment objectives. Actively managed funds should not be expected to retain the same portfolio, without any material changes, for a substantial amount of time.

iii. Materially different portfolios

The Revenue Ruling requires that the RIC's portfolio differ materially after a redemption in kind that was part of a predetermined plan to redeem contributed securities. This suggests that the Revenue Ruling would not apply if an ETF had a plan to redeem in kind contributed securities, and did so, if the resulting portfolio is not materially different from the contributed portfolio. Presumably, some amount of pre-planned portfolio turnover is acceptable. The amount of acceptable portfolio turnover remains unclear. If additional guidance is contemplated addressing materially different portfolios, we recommend that any guidance addressing portfolio turnover be clearly limited to redemptions in kind from funds formed by 351 conversions pursuant to a plan described in the Revenue Ruling, to avoid disrupting the vast majority of redemptions in kind occurring in the normal course of managing an ETF's portfolio.

Some asset managers may interpret "materially different" in relation to the consistency and investment thesis concepts in the Revenue Ruling, and assume that the portfolio contributed in the 351 transaction will only be considered "materially different" from the portfolio resulting from the planned redemption in-kind transactions if the contributed portfolio was not consistent with the ETF's investment thesis. We are not recommending this interpretation, only sharing it to demonstrate different interpretations of a material difference in portfolios under the guidance. Also consider whether an ETF seeded in part with shares of other RICs should look

[18] 40% of 351 ETFs Would Have Violated New Treasury Rules, Brian Ponte, *Ignites* (Oct. 19, 2026).

through the RICs to their assets for purposes of assessing materially different portfolios, consistent with current look-through guidance under sections 351 and 368.[19]

The Revenue Ruling is based primarily on Code section 1001, which has regulations referencing a material difference. The *Cottage Savings*[20] case and subsequent case law also address a material difference in assets. Under the *Cottage Savings* test, properties are materially different when their respective possessors enjoy legal entitlements that are different in kind or extent. In the context of redemptions in kind from RICs, the *Cottage Savings* standard would be very restrictive, causing almost any redemption in kind to result in a different portfolio, potentially excepting only pro-rata redemptions in kind, although even these are rarely 100% pro-rata to the RIC's investment portfolio. Such a restrictive rule may not supply an administrable standard for comparing differences in an ETF's portfolio.

iv. Example

As an example of uncertainty about these undefined terms, consider a scenario where a group of investors with diversified portfolios of assets managed with a specific strategy are matched with an asset manager interested in launching an ETF that operates the same general investment strategy, a diversified actively managed U.S. large cap equity portfolio. The ETF sponsor determines that all stocks in the investor's portfolio would be suitable investments for the ETF to hold, and consistent with a U.S. large cap equity strategy, but some securities are not ideally suited to the exact investment portfolio that the ETF would like to construct, or are slightly over- or under-concentrated and so the ETF would plan to reposition the portfolio post-conversion to arrive at its ideal portfolio. Examples of intended repositioning include:

- The investor's portfolio may include one or more securities that are part of, but slightly overweight relative to, the ETF sponsor's ideal portfolio (e.g., X Corp represents 8% of the contributing investor portfolios and 7% of the ETF's desired portfolio);
- One or more US large cap equity securities in the investor portfolios may be securities in the banking sector. The ETF wants bank stocks in its portfolio, but from a different issuer (e.g., the investor holds Y Bank and the ETF ideal portfolio includes Z Bank); and/or
- The investor's portfolio may include certain US large cap equity securities that are consistent with the ETF's investment strategy (US large cap equities) but are in a sector of the economy that the ETF does not want exposure to, for example, airline stocks.

Are any or all of these scenarios in scope for the Revenue Ruling, or is the Revenue Ruling inapplicable because all contributed securities are consistent with the ETF's investment strategy (U.S. large cap equities)? Which differences are relevant and to what extent? Does

[19] The look-through rule of § 368(a)(2)(F) applies for purposes of diversification testing under § 1.351-1(c)(6)(i).

[20] 499 U.S. 554 (1991).

the answer depend partly on how much portfolio turned over, or whether they post-redemption portfolio is materially different than the securities contributed by investors?

4. Deemed Sale Proceeds

The Revenue Ruling does not describe the consideration deemed received by the contributing investor, or the applicable valuation date, or any subsequent deemed transactions through which the investor acquires ETF shares. The characterization should account for the investor's ownership of ETF shares at the completion of the transactions. The investor could be deemed to receive either:

- cash, with no additional steps
- cash, which is then used to purchase shares of the ETF
- cash, which is then contributed to the ETF in the 351 conversion in exchange for ETF shares,
- the assets that were contributed by the AP to the ETF in the creation transaction, which would then be contributed to the ETF in the 351 conversion in exchange for ETF shares,[21] or
- ETF shares.

We recommend that the investor be deemed to receive ETF shares, either directly, or through some deemed purchase or 351 conversion because the investor does in fact hold ETF shares upon completion of all transactions. If the sales consideration is deemed to be ETF shares, or other non-cash assets, then it is also unclear if those assets should be valued at the time the ETF is formed, or at the time of the redemption in kind.

5. Effect of Deemed Sale on 351 Analysis

The Revenue Ruling does not address whether a deemed sale requires reassessment of the remaining transaction under section 351, including the diversification requirements of Treasury Regulation § 1.351-1(c)(6) and the control requirement. Guidance should address separately the consequences for the deemed seller and for other contributing investors, particularly investors who did not participate in the plan. It should also clarify whether any deemed contribution of cash is taken into account in determining control, for example, if the deemed sellers were also deemed to contribute cash to the ETF in exchange for ETF shares, as part of the 351 conversion.

6. Other Unresolved Tax Implications of a Deemed Sale

The deemed sale holding presents several other unresolved tax issues for consideration:

[21] The investor generally would not have information about the securities contributed by the AP, unless the ETF informed the/m.

- Identifying Tax Lots of Shares Deemed Sold. If an investor contributes securities with multiple tax lots, and the ETF redeems less than the entire position, which tax lots are deemed to be sold and retained?
- Effect of Deemed Sale on Subsequent Investment Activity. If securities deemed sold generate investment income after contribution but before sale, is that income taxed to the deemed seller, or to the ETF?
- Effect of Deemed Sale on the ETF. If some portion of the securities contributed to the ETF are deemed sold, then presumably the ETF's cost basis and holding period in those securities would need to be adjusted. The ETF's cost basis and holding period in securities depends on the prior question of which tax lots were deemed sold. ETFs are required to file financial reports with the SEC that disclose the fund's unrealized gain. The ETF's investment income depends on the prior question of which taxpayer incurs tax on investment income from the securities deemed sold, which also impacts the ETF's financial reporting, distributions, shareholder tax reporting, and potentially its net asset value (NAV).

D. 351 Conversions by Exchange Funds – Notice 2026-62

Section 2.03(2) of the Notice describes a transaction where an exchange fund forms a new ETF in a transaction intended to qualify for nonrecognition treatment under section 351. As part of the same plan, the ETF then redeems in kind securities contributed by the exchange fund resulting in a materially different portfolio, in the same transaction as described in the Revenue Ruling. The Notice states that "[t]he Treasury Department and the IRS continue to consider other guidance that would provide that the contributions to partnerships described above do not qualify for nonrecognition of gain or loss or otherwise may be recharacterized in a manner that reflects the proper substance of the underlying transactions for federal income tax purposes."

We are not aware of ICI members engaging in these transactions. The Revenue Ruling seems to apply to this transaction, as suggested in the Notice, recharacterizing the transaction as a deemed sale between the partnership and the ETF's AP. The Notice suggests that it may be appropriate to further recharacterize the contribution of securities to the partnership. For example, if the step-transaction doctrine were applied, and the initial transfer of appreciated securities to the exchange fund was considered to be part of the overall plan, the transaction could be further recharacterized as a deemed sale between the investors in the exchange fund who contributed securities subsequently redeemed in kind by the ETF, and the ETF's AP that received those securities in redemption of ETF shares. If so, we encourage Treasury and IRS to consider our comments on the Revenue Ruling, requesting additional clarification of the deemed sale proceeds and price, the taxation of investment income in the intervening period, and whether the deemed sale recharacterization would require retesting for nonrecognition under sections 721 and 351. We also encourage Treasury and IRS to consider the application

of section 704(c) principles to such a transaction. It is possible that application of the Revenue Ruling in combination with section 704(c) renders additional guidance on this transaction unnecessary.

III. Certain Other Uses of Redemptions in Kind – Notice 2026-62

The Notice describes three other specific uses of redemptions in kind: box spread funds, record date strategies, and RIC income test avoidance. These strategies seem to use redemptions in kind to change the tax character of income or gain in the fund or circumvent the RIC qualifying income test. We recommend that any guidance addressing these strategies should be narrowly tailored to character conversion strategies and strategies designed to systematically circumvent the RIC qualifying income test, and should exclude other strategies that share some similar characteristics, but that do not implicate these policy considerations, or that otherwise have a substantial non-tax investment purpose.

A. Box Spread Funds

Section 2.04 of the Notice describes the box spread fund strategy as "a combination of four options on the same underlying property that, in the aggregate, produce a return similar to a short-term interest rate." The options are not section 1256 contracts. The ETF separates the appreciated and depreciated options and redeems in kind the appreciated options before expiration. "As a result, the ETF purportedly avoids recognition of any income or gain from the box spread, and investors purportedly recognize no current income although they economically benefit from a return consistent with a short-term interest rate."

Our primary recommendation for guidance addressing the box spread strategy is to: (1) narrowly define the box spread strategy to address Treasury's concerns about tax character conversion, and (2) not broadly address other option or derivative strategies. For example, many ETFs use options to deploy specific investment strategies that cannot be achieved without options and that retail investors often could not otherwise access, or to manage specific portfolio risks. A comprehensive summary of these funds and option strategies is beyond the scope and timing limitations for these comments; however, we mention them to emphasize that RICs use options extensively, for non-tax investment purposes, and future guidance addressing box spread strategies should be limited in scope to prevent disruption to well-established RIC options usage. We also recommend clarifying whether funds that redeem both the appreciated and depreciated options would be in scope for the Notice, or only those that redeem only appreciated options in kind.

B. Record Date Strategies

The Notice described a record date strategy as an ETF that invests in other ETFs (acquired ETFs), and that takes the position "under § 852(b)(6) that recognition of dividend income can be avoided by making a redemption distribution of the stock of the acquired ETF prior to the record date…. 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 purpose of the disposition of one acquired ETF and the acquisition of a replacement acquired ETF is to eliminate taxable dividend income without any material change to the economic characteristics of the assets of the parent ETF." While the Notice is relatively clear about the strategy it is intended to address, it leaves some uncertainty on scoping, which we recommend resolving if future guidance is issued.

First, the Notice is not entirely clear about whether the strategy applies only when the acquired ETFs are same-index ETFs, or whether it could also apply to acquired ETFs that are not index ETFs. The initial description does not specify that an acquired ETF must be a same-index ETF. The Notice then provides an example, where the acquired ETF is a same-index ETF. It concludes by stating that "[t]his notice does not address transactions involving ETFs that invest in other ETFs that track different indices, and this notice is not intended to express a view regarding such transactions." Index ETFs are often economically equivalent in a way that any other two ETFs likely are not, and for this reason, we recommend that any future guidance be limited to acquired same-index ETFs.

Second, the Notice does not address ETFs investing in anything other than ETFs. We assume that the Notice was intended to also apply to ETFs using index mutual fund RICs tracking the same index in the same manner to achieve the same outcome. The Notice does not address ETFs investing in equities, and redeeming shortly before dividend dates, which seems less concerning because equities rarely have economically equivalent alternative investments, as many equity index ETFs do. We recommend that any future guidance on record date funds should not be extended to any acquired assets other than same-index RICs.

Third, the strategy described seems to require redemptions in kind, which implies that if the ETF has instead sold the appreciated acquired ETF prior to the dividend record date, the guidance would not apply. While we agree that a sale would fall outside the scope of the Notice, we note that selling the acquired ETF could also result in character conversion, as dividend income is converted into capital appreciation.

Fourth, we suggest that intent should be the guiding principle in this transaction, as the Notice refers to the "purpose" of eliminating taxable dividend income. We agree. While intent is often difficult to assess, a recurring pattern of substitutions around dividend dates, together with contemporaneous materials describing a dividend-avoidance objective, may be relevant evidence of intent. No single redemption shortly before a dividend date should, standing alone, establish such intent. Focusing on intent differentiates this record date strategy from other funds of funds, which is critical. The ETFs described in the Notice are a subset of funds of funds.

Funds of funds have been common and widely used for decades and present no similar concerns with tax character conversion. A fund of funds is simply any RIC that primarily holds

shares of other RICs. Perhaps the best-known funds of funds are target date funds, which typically hold an equity RIC and a bond RIC and rebalance between the two to maintain the targeted percentage allocation over time. Other funds of funds allocate between other RICs based on some other investment strategy, premise, or formula based on factors such as economic cycles, market volatility, or sector allocations. ETFs that are funds of funds may use in-kind redemptions and subscriptions to rebalance between the underlying funds. By coincidence, redemptions may shortly precede dividend payment dates for the underlying RICs, but over time, these funds of funds should not demonstrate a recurring or intentional pattern of redeeming prior to a dividend date for the purpose of avoiding dividend income.

C. RIC Income Test Avoidance

The last RIC-specific strategy described in the Notice is RIC income test avoidance, where "[s]ome ETFs are taking the position that § 852(b)(6) permits them to circumvent the income test in § 851(b)(2) by avoiding the recognition of gains with respect to distributed assets that would not be qualifying income. The ETFs invest directly in assets that, upon a sale or exchange, would produce gains not described in § 851(b)(2). For example, the ETF might hold positions in commodities or digital assets, either by holding those assets directly or by investing in a grantor trust that holds these assets. These ETFs avoid recognizing gain that would be non-qualifying income by distributing the assets that would produce the gain in redemption of creation units."

Intent should be the primary consideration in assessing RIC income test avoidance, similar to other strategies described in the Notice. RICs that routinely and intentionally acquire and redeem assets with actual knowledge that they generate nonqualifying income seem squarely within scope of the Notice. Patterns of behavior may be indicative, as RICs that repeatedly acquire and redeem assets generating nonqualifying income seem to demonstrate an intent to circumvent the qualifying income test. We recommend that any future guidance distinguish intentional income-test avoidance from redemptions of assets acquired inadvertently such as through corporate actions. Relevant facts should include the circumstances of acquisition, the fund's compliance policies and prior practices, and the absence of a recurring strategy of acquiring and redeeming assets that would generate nonqualifying income.

RICs occasionally unintentionally acquire assets that may generate nonqualifying income. For example, in "bail-in" debt workouts, the RIC may hold an asset generating qualifying income, such as debt, then have its debt converted to equity, such as a partnership equity interest that may generate nonqualifying income.[22] Other corporate actions may result in a RIC receiving an asset that generates nonqualifying income. Any future guidance addressing RIC income test

[22] We note that income and gain from such assets may still be qualifying income, as income from the fund's business of investing in securities, attributable to the asset originally acquired.

avoidance should consider that RICs occasionally unintentionally acquire assets generating nonqualifying income.

The Notice also does not address the 10% buffer for nonqualifying income in the qualifying income test. It notes that section 851(b)(2) requires at least 90% of the RIC's gross income to be qualifying income, but does not acknowledge the negative inference, that RICs can satisfy the qualifying income test if their nonqualifying income is less than 10% of their gross income. We recommend that RICs redeeming in kind assets that would have generated nonqualifying income or gain if sold should not be deemed within the scope of the Notice if either:

- The RIC would have passed the qualifying income test if it had instead sold the redeemed securities,[23] or
- The securities generating nonqualifying income or gain were a small portion of the fund's portfolio and were redeemed pro-rata with other securities generating qualifying income or gain.[24]

While many RICs have zero-tolerance policies toward nonqualifying income, some are willing to accept some small amounts of nonqualifying income or gain. RICs that intentionally acquire assets generating nonqualifying income should not be deemed to avoid the income test if they intended to manage their nonqualifying income within the 10% limit.

IV. Other Strategies Used by Tax-Aware Funds – Notice 2026-62

Regulated funds collectively hold significant positions in foreign currency contracts, notional principal contracts (NPCs), and identified straddles, although we are not aware of regulated funds using the other specific tax-aware investment strategies described in Section 3 of the Notice. RICs are not effective fund structures for ordinary loss harvesting strategies, because they cannot take a net operating loss deduction, so net ordinary losses do not offset future ordinary income. Our comments on these strategies are limited to distinguishing common usage of these derivatives by regulated funds from the strategies described in the Notice, and

[23] For example, if a RIC intentionally invested 1% of its assets in an asset generating nonqualifying income and monitored its appreciation to ensure that the unrealized gain wouldn't exceed 10% of gross realized income and gain, if sold, it should not be presumed to violate the qualifying income test if it subsequently redeems the asset in kind.

[24] For example, assume a RIC holds 50 positions, each representing 2% of the Fund's portfolio. Assume that asset A, which generates nonqualifying income and gain, represents 2% of the portfolio. The RIC will need to announce to APs that asset A represents 2% of the standard redemption or creation basket. If an AP places a redemption order to close the discount or premium between the value of the standard basket and the ETF's share price, the ETF will have to distribute a pro rata slice of its assets including asset A to satisfy the redemption request. The in-kind delivery Of asset A is not motivated by tax or qualifying income purposes. It would very difficult to review all standard-basket redeem transactions, daily, trying to identify positions for which outright sales would have generated nonqualifying income and to instead treat the in-kind nonrecognition transaction as causing a recognition event solely with respect to asset A.

if Treasury and IRS are considering changes to the current tax regime for these derivatives, encouraging them to carefully consider potential implications for funds using these derivatives for non-tax-related investment purposes.

A. Identified Straddles Used to Convert Character

Regulated funds investing in foreign equities or bonds often use foreign currency futures or forwards to hedge foreign currency risk associated with those investments. Hedging out foreign currency gains and losses to the US dollar limits shareholder exposure to variations in the value of the US dollar relative to the currencies in markets where the fund invests. Regulated funds often make identified straddle elections pairing these foreign currency contracts, which short the foreign currency, with the equities or bonds denominated in those foreign currencies. This hedging seems easily distinguished from the identified straddles used to convert character described in section 3.02(2) because:

- The offsetting positions are not both foreign currency contracts, but instead are an asset held for long-term investment purposes, generally stocks and bonds, and a foreign currency contract
- Funds using foreign currency futures to hedge currency risk do not intentionally and repetitively terminate the futures contract (if any) prior to the offsetting position in the identified straddle
- Funds often make section 988(a)(1)(B) elections to receive capital gain or loss on the currency hedge, to match the character of gain or loss on the hedged assets (stocks and bonds) with the character of the gain or loss on the hedge.
- Foreign currency hedging in investment funds serves a non-tax business purpose (currency risk hedging) not motivated by tax implications.
- Regulated funds generally identify their straddles systematically, not selectively, by using identified straddle accounts and specific ordering rules to match the currency hedge to the assets hedged.

B. Same-Day Foreign Currency Transactions with Selective Section 988(a)(1)(B) Elections

Many regulated funds make section 988(a)(1)(B) elections, generally to align the tax character of their foreign currency hedges with the character of gain and loss on the assets hedged (stocks and bonds). Their section 988(a)(1)(B) elections are distinguished from those described in section 3.03 of the Notice because:

- We are not aware of any regulated funds intentionally opening and closing foreign currency contracts on the same day, although it may happen rarely and coincidentally due to unforeseen circumstances arising during the day.
- Funds generally make systematic, not selective elections. Generally, elections are made consistently for all foreign currency contracts acquired by the fund, and are not dependent or contingent on gain or loss on the contract.

C. Selective NPC terminations used to obtain inconsistent character

Likewise, many regulated funds use swaps taxed as NPCs to hedge certain investment risk, or gain access to certain asset classes. For example, bond funds often use interest rate swaps, to convert between fixed and variable interest, and credit default swaps to hedge against default risk. They apply the NPC tax regulations of section 1.446-3 to these NPCs, as applicable.[25] Again, regulated fund usage of NPCs is easily distinguished from the selective terminations described in the Notice because:

- The NPCs that regulated funds most often use have regularly scheduled periodic payments, and do not have large contingent payments scheduled immediately prior to termination, as described in the Notice.
- Treasury and IRS's concern focuses partly on the intent to generate ordinary losses to offset wage income, which is not possible in RICs because RICs are not allowed a net operating loss deduction.

V. Conclusion

In summary, ICI recommends that if Treasury and IRS issue additional guidance, it should (1) limit such guidance to the specific transactions described in the Notice and Revenue Ruling; (2) apply it prospectively, with transition and remediation relief for any retroactive application; (3) clarify the terms "plan," "shortly thereafter," "investment thesis," and "materially different," and resolve the open questions on deemed sale proceeds and their consequences; (4) define the box spread, record date, and RIC income test strategies narrowly, with intent as the guiding principle; and (5) distinguish the tax-aware strategies described in the Notice from the routine, non-tax uses of derivatives by regulated funds.

ICI appreciates the opportunity to comment, and would welcome the opportunity to discuss, clarify, or expand on these recommendations and provide additional examples, if helpful.

Sincerely,

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[25] Application of the NPC rules to certain credit default swaps is not entirely settled.