Published on *The National Law Review* https://natlawreview.com

Proposed Tax Legislation Could Impact Exchange-Traded Funds

Article By:

John S. Marten

Jacob C. Tiedt

Nathaniel Segal

Jake W. Wiesen

On September 10, 2021, Senator Ron Wyden (D-Oregon), Chairman of the U.S. Senate Committee on Finance, proposed draft legislation aimed at eliminating certain perceived loopholes and ambiguities in the tax rules applicable to partnerships and other pass-through entities. Notably, the proposed legislation would repeal a tax code provision, Section 852(b)(6), that allows regulated investment companies (RICs), including mutual funds and ETFs, to avoid recognizing gain on appreciated securities when they satisfy shareholder redemptions in kind (i.e., providing portfolio securities rather than cash in exchange for fund shares).

Although the repeal of Section 852(b)(6) would impact redemptions in kind made by both mutual funds and ETFs, the tax preference afforded to in-kind distributions provided by Section 852(b)(6) is at present a key advantage of the ETF structure. Unlike mutual funds, which typically satisfy shareholder redemptions in cash, most ETFs rely on the ability to effect in-kind creations and redemptions of shares with authorized participants in the normal course of their operations and thereby avoid realizing taxable gains on appreciated securities. A repeal of Section 852(b)(6) would require ETFs to recognize gains on any appreciated securities distributed to authorized participants in routine in-kind redemptions. As a result, because RICs are required under the tax code to distribute substantially all of their income and gains each year to avoid U.S. federal income tax at the fund level, ETFs would need to distribute to shareholders gains recognized on in-kind redemptions, which generally would be taxable to shareholders unless their shares are held in a tax-advantaged account. In addition, ETFs may need to sell securities in order to raise cash to satisfy this annual distribution requirement, potentially incurring transaction costs and generating additional gains. This change would therefore eliminate a key advantage ETFs currently enjoy vis-à-vis traditional mutual funds.

If the proposed legislation is enacted, the repeal of Section 852(b)(6) would apply to taxable years beginning after December 31, 2022.

A copy of the proposed legislation is available here, and a section-by-section summary is available here.

National Law Review, Volume XI, Number 288