Introduction to the 351 ETF Exchange

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Introduction

Over the past few decades, investors have come to appreciate the ETF structure for numerous reasons—intraday liquidity, low fees, and tax efficiency. These features have led to investors voting with their dollars, and flows have been consistent from traditional high-fee, tax-inefficient vehicles into the ETF structure.

To borrow and alter a quote from Marc Andreessen, we believe that "ETFs are eating the asset management industry (in a good way!)."

However, while investors appreciate the ETF's inherent tax efficiency, they often hold legacy stock positions with big capital gains. Selling their holdings and transitioning to an ETF would require a hefty tax bill.

Is it possible to transition their low-basis investments into the ETF structure tax-efficiently?

The answer is a 351 tax-free conversion.

Below, we address the basics of ETF taxation and 351 tax-free conversions. The discussion features contributions by Bob Elwood, a practicing tax attorney with extensive experience in these areas.

If you'd like to discuss this further, please contact Meb Faber and the Cambria team via this link or directly at info@cambriainvestments.com.

An Overview of the ETF Structure and Tax Advantages

First, let's review the tax efficiency of the ETF structure. Generally, holding an ETF in a taxable account will generate a smaller tax liability than if the investor held a similarly structured separately managed account (SMA), private fund, or mutual fund in the same account (other than a tax-advantaged account like an IRA).

Specifically, the ETF structure takes advantage of the In-Kind Creation and Redemption Process that allows authorized participants (APs) to exchange a basket of securities (or other assets) for ETF shares. When an investor sells ETF shares, the ETF doesn't need to sell the underlying assets to raise cash. Instead, authorized participants redeem ETF shares for the underlying securities. This process is called "in-kind" and in most cases doesn't generate capital gains at the fund level. By avoiding sales of securities, the fund can avoid realizing taxable gains, meaning the investor won't have to pay capital gains taxes 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").

Because ETFs typically don't distribute capital gains, investors don't face taxes until they sell their ETF shares, allowing for better control over the timing of the tax event. This tax deferral means the investor can defer the realization of capital gains and let their investment grow tax-free until they decide to sell. Deferring capital gains can lead to substantial growth due to the compounding effect over time. Taxes on capital gains are only realized when the investor sells their ETF shares.

Is there a way to seed an ETF launch with highly appreciated investments?

What is a 351 to ETF Conversion?

Many investors are familiar with 1031 real estate transactions and stock "exchange funds" – both have been a feature of the tax code for over 100 years. These structures are similar in concept in that they allow for tax deferral of appreciated assets but differ in numerous ways.

A 351 to ETF conversion refers to a tax-related mechanism under U.S. tax law, specifically Section 351 of the Internal Revenue Code. This mechanism allows for the transfer of assets (such as stocks, securities, or other property) to a corporation without recognizing a taxable gain or loss, provided certain conditions are met.

In the context of an ETF, a 351 exchange would typically involve the transfer of assets to a fund in exchange for shares in that fund without triggering a taxable event.

In other words, you can contribute an investment portfolio and “seed” the launch of an ETF, and receive a diversified ETF in exchange.

How Does an SMA to ETF 351 Conversion Work?

The individual investors will contribute securities to a newly formed ETF in exchange for shares of the ETF.

Under Code Section 351(a), no gain or loss is recognized if the 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.

Three primary things to remember as you consider the Proposed Transaction: special rules, diversification, and control.

1. **Special Rules for Transfers to Investment Companies:** Under Treas. Reg. Section 1.351-1(c)(6), portfolios of stocks and securities that are already diversified 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.

2. **Diversified Assets:** 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 single holding can be greater than 25%** of the total portfolio being contributed.
   - **Positions greater than 5% can’t collectively be more than 50%** of the portfolio’s net asset value.
   - For purposes of these rules, all members of an affiliated group of corporations are treated as one issuer. (This usually only occurs occasionally in connection with things like stock tracking.)
   - 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”:** 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.

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, there should be no trouble with the “control” requirement.

At the end of this summary, we include examples of portfolios that do and do not qualify as diversified assets.

What are the Tax Consequences of SMAs That Convert Into an ETF?

Post ETF conversion, tax consequences can be broken down into two buckets, tax consequences to the ETF, and tax consequences to the investors.

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.

Additional Important Considerations for Financial Advisors Pursuing 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 on an 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.

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.

If you'd like to discuss further, please contact Meb Faber and the Cambria team via this link.

EXAMPLES OF PORTFOLIOS THAT DO AND DO NOT QUALIFY:

QUALIFIES:

- An investor wants to contribute a portfolio consisting of 20% Nvidia stock and 80% assorted stock holdings, each representing approximately 1% of the positions.
- An investor wants to contribute a portfolio consisting of 100% SPY ETF.
- An investor with a 20-stock portfolio that is roughly equal weighted.

DOES NOT QUALIFY:

- An investor with a Schwab brokerage account wants to contribute a portfolio consisting of 50% Nvidia stock and 50% cash.
- An investor with a portfolio of mutual funds.
- An investor with a portfolio of DogeCoin.

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