Section 351 ETF Conversion FAQs

What can I contribute?

ELIGIBLE:
Stocks, ETFs, and ADRs.

NOT ELIGIBLE:
Mutual Funds, Cryptocurrency, Options, Private Investments, Restricted Stock, and Closed-End Funds.

Is there a minimum contribution limit?

For our first launch in December 2024, we are setting the individual minimum at $1,000,000. However, we hope to reduce the minimum contribution to $100,000 as we roll out more section 351 ETF conversions in 2025.

How does the section 351 ETF conversion process work?

The process varies slightly by custodian, and some make it easier than others. Below is an approximate timeline of events:

- Individual or advisor submits interest and portfolio details to Cambria.
- Cambria, ETF Architect, and an independent tax lawyer do an analysis of the contributed securities to confirm eligibility, diversification and control requirements are met.
- If all requirements are met, Cambria will submit a package for signature containing KYC client affirmations, a tax opinion, a representation letter and the custodian paperwork to the individual or advisor to distribute to the end clients. In most cases this package will be eligible for DocuSign, but this may vary by custodian. Completed paperwork must be received 2 weeks prior to the fund's expected launch date. In addition to the completed documents, Cambria will need information from the client custodian regarding tax lot details so these can be applied to the ETF shares they will receive.
- Once the executed documentation is received, Cambria and ETF Architect will begin working with the custodian's operations team to prepare everything for transfer. Two days prior to the ETF launch date, the contributed shares will be debited from the client's custody account and credited to the ETF's custody account at US Bank. On the day prior to launch, the value of contributed securities will be struck using the closing price. On launch date, the proportionate dollar value of ETF shares will be created and delivered back to the respective custodians who will credit them into client's accounts.
- Following the launch, Cambria and ETF Architect will work with the respective custodians to apply the client's cost basis and holding period from the transferred securities to the ETF shares.

How are diversification requirements on contributions calculated?

Diversification requirements on contributions are calculated on both the individual level and the aggregate fund level.

- **Individual level** - A single position cannot be greater than 25% of the total contribution and the top 5 positions cannot be greater than 50% of the total contribution.
    - If an investor is contributing an ETF, we look through to the underlying holdings. This simplifies the process since most ETFs are already diversified.
    - **Example:** If a contributed portfolio had a 30% position in SPDR S&P 500 ETF (SPY), that would exceed the 25% threshold listed above, except that as an ETF the analysis would be performed on the 500 underlying holdings, which easily meet the diversification limits.

- **Aggregate level** - The combined contributions of all individuals need to pass RIC asset diversification requirements.
  - The largest aggregate position can't be greater than 25% of the fund.
  - All aggregate positions greater than 5% can't be greater than 50% of the fund.

Can I really avoid paying taxes?

To quote Ben Franklin, "Nothing is certain except death and taxes." A 351 exchange does not eliminate your capital gain obligation but defers it. When transferring assets via a section 351 ETF conversion, the cost basis on the transferred securities will be carried forward and applied to the shares of the ETF you receive. When you sell your position in the ETF, you will pay capital gains based on your original cost basis and holding period adjusted for any gains, losses, or other impacts incurred while holding the ETF.

What are the tax consequences post conversion?

From the ETF's perspective, the fund 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 an SMA contribution has 0 basis in a portfolio of assets, the ETF will have a 0 basis in the same assets. The investor will have no taxable gain or loss on the conversion. They will have a carryover basis and carryover holding period in the ETF shares corresponding to the basis and holding period of the transferred assets.

How is this different than an exchange fund?

Exchange funds are limited partnerships sponsored by banks or brokerage firms. The limited partnership structure utilizes section 721 of the Internal Revenue Code, enabling accredited investors to contribute single security stock positions without actually selling and incurring capital gains. Investors who participate receive partnership units in a diversified portfolio of stock initially contributed by a group of investors that the general partner ultimately manages to pursue a specific goal.

While exchange funds are like a section 351 ETF conversion in that both allow tax deferral a 351 conversion relies on Treasury Regulation Section 1.351-1(c)(6) to defer the realization of capital gains. Between these two tax deferment options there are three key differences:

1. **Availability:** Exchange funds are only available to accredited investors, whereas a section 351 ETF conversion is available to all investors.
2. **Cost/lockup:** Exchange funds typically charge an initial fee of 1-2% on the contributed asset, a management fee of 1-2%, and a 7-year lockup period. A section 351 ETF conversion does not charge an initial fee, generally has a lower management fee (think ETF expense ratio), and does not have a lockup period.
3. **LP vs ETF Structure:** We may be biased, but we truly believe that the ETF structure is one of the most innovative and shareholder-friendly tools available to investors.

   - The ETF structure takes advantage of the In-kind creation/redemption process, allowing authorized participants (APs) to exchange a basket of securities (or other assets) for ETF shares. The "in-kind" process doesn't typically 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 until they sell their shares of the ETF since the in-kind redemption activity is not taxable to the ETF. This is all thanks to Section 852(b)(6) of the Internal Revenue Code of 1986.

   - Exchange funds, mutual funds, and other investment vehicles cannot defer capital gains. Whether the fund activity is investor-driven or rebalance-driven, all capital gains or losses are passed to the underlying shareholders in the year they are realized.