The following discussion is not tax advice and provides only a high-level summary of the expected material federal income tax consequences to investors who contribute property to an ETF on its initial closing. This discussion does not address non-income taxes or state or local income tax consequences. Further, this discussion does not address investors in special situations (such as financial institutions, non-U.S. persons, insurance companies, entities exempt from federal income tax, regulated investment companies, dealers in commodities and securities, and pass-through entities). Investors should consult their own tax advisors regarding the tax treatment of their contribution of assets to the ETF in exchange for ETF interests.

At launch only, 351 conversions allow investors to seed an ETF with individual stock and ETF positions. If each Transferor meets the diversification requirements, they can convert their old positions to the new ETF in a non-taxable transaction. The Transferors will generally have both a carryover basis and carryover holding period in the ETF shares that correspond to the basis and holding period of the transferred assets.

What is a 351 Transaction?

A 351 transaction, contribution, or exchange refers to a section of the Internal Revenue Code that deals with contributions to controlled corporations (often used for newly formed corporations). This code section allows for a tax-free exchange of securities into a newly created entity, such as an ETF, provided certain diversification rules are met. In other words, the Code allows individuals to exchange holdings of stocks or ETFs into a new ETF in a tax-free conversion with carryover basis.

How Does a 351 Transaction Work?

Individual investors (collectively, the "Transferors") contribute a diversified portfolio of securities to a newly formed ETF (the "ETF") in exchange for shares of the ETF.

Under IRS Code Section 351(c), portfolios of stocks and securities that are already diversified, such as an ETF, can be treated as a diversified portfolio of stocks and securities such that they can be transferred to an investment company under Section 351(a).

Under IRS 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.

Although not the sole requirements to be treated as a tax-free contribution under Section 351, the above provisions highlight two important limitations on a 351 transaction that are important to focus on in connection with contributing stock and securities to an ETF: Control & Diversification.

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What are the Important Limitations on 351 Transfers to an ETF to Consider?

1. Diversification

The IRS does not want parties to be able to make non-taxable transfers to an investment company in order to achieve diversification of a non-diversified portfolio. Accordingly, the transfer to an investment company cannot be non-taxable unless the portfolio being transferred to the ETF is already diversified. Each transferor must meet the following diversification standards:

- No more than 25% of the value of the total assets being contributed can be the stock of any one issuer. In other words, the biggest position cannot be more than 25%.
- No more than 50% of the value of the total assets being contributed can be the stock of any five issuers. In other words, the top five positions cannot be more than 50%.
- In determining total assets, an investor must exclude cash and government securities.
- If an investor transfers a regulated investment company, like an ETF, the portfolio gets the "look-through" treatment. In other words, an S&P 500 ETF would not count as one position because the IRS "looks through the portfolio to see that each underlying position held in that ETF is considered an individual position for purposes of the diversification rule. While not all ETFs are going to be treated as a diversified portfolio on a look-through basis, we would expect that most ETFs that are treated as regulated investment companies under the Code will be, because regulated investment companies have a similar diversification requirement that they must meet.
- Note that although spouses are viewed as separate taxpayers, the IRS has issued private letter rulings allowing one spouse to transfer assets to another spouse prior to a contribution of assets to a corporation in order to allow the contribution to avoid diversifying a non-diversified portfolio.[1]

2. Control

A transfer of assets by one or more parties solely in exchange for the stock of a registered investment company (an ETF) does not give rise to the recognition of gain or loss if, immediately after the transfer, those parties are in "control" of the ETF. "Control" is defined as the ownership of stock possessing 80% of the voting and non-voting power. For an ETF, this would mean owning over 80% of the shares of the ETF. At the launch of an ETF, the Transferors will constitute a control group and will have well over 80% of the value of the ETF. Subsequent contributors are not likely to qualify as Section 351 contributions.

What are the logistics of an ETF 351 Transfer?

Before converting to an ETF, Transferors must provide permission for the conversion. Investors must sign a letter detailing the impending conversion, the time frame, and what assets will be transferred.

Each client must provide the purchase date and cost basis information for every position transferred, so that the ETF sponsor can determine and track the basis and holding period information.

Note that in the case of a contribution of depreciated assets, investors will not be able to recognize a taxable loss. The assets' basis will generally be reduced in the ETF's hands to fair market value.

Although this discussion is considered to be a correct interpretation of applicable law, no assurance can be given that the Internal Revenue Service or a court will agree with such interpretation or with the tax positions taken by the ETF. You are encouraged to consult your own tax advisor with respect to your contribution to the ETF.

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[1] Private letter rulings may only be relied upon by the taxpayer to whom they are issued but can give insight as to the IRS's view on a matter. Potential investors should consult their own tax advisors regarding the impact of a transfer between spouses in anticipation of a contribution of assets to a corporation.

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