

IRS Puts Investment Fund Tax Strategies Under the Microscope: What Fund Managers Need to Know

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KEY POINTS

- Treasury and the IRS issued Notice 2026-62 and Revenue Ruling 2026-20 together, targeting Section 852(b)(6) ETF redemption strategies and “tax-aware” hedge fund structures as potentially abusive.
- Revenue Ruling 2026-20 already treats Section 351 ETF “conversion” transactions as taxable sales, meaning investors who used this strategy may owe tax now.
- Notice 2026-62 flags three tax-aware fund strategies — Section 1092(a)(2) mixed-character straddles, same-day Section 988(a)(1)(B) currency elections, and Section 1234A swap terminations — that pair capital gains with ordinary losses.
- Treasury warns that new guidance on these strategies could apply retroactively to transactions that have already closed.

The Treasury Department and IRS have issued Notice 2026-62 and a companion ruling, Revenue Ruling 2026-20. Together they tell the investment management industry that several widely used exchange-traded fund (ETF) and fund tax strategies are now squarely in the government’s crosshairs. The notice names specific structures the government views as potentially abusive and warns that new rules, which could reach back to transactions already completed, may follow. If your fund uses any of the strategies described below, you should evaluate your exposure now.

THE STRATEGIES UNDER SCRUTINY

The notice targets two broad categories of fund strategies.

ETF Redemption-Based Strategies

Section 852(b)(6) of the Internal Revenue Code lets an ETF hand appreciated securities to departing shareholders instead of cash, without the ETF itself paying tax on the built-in gain. That feature is a major reason ETFs are more tax-efficient than traditional mutual funds. The government is not challenging this basic mechanism. It is challenging strategies that stretch Section 852(b)(6) well beyond its original purpose:

- **“Conversion” transactions using Section 351.** Section 351 generally allows investors to contribute assets to a corporation without triggering a tax bill, as long as certain conditions are met. Some advisors have promoted

structures in which investors contribute appreciated securities to a newly formed ETF under Section 351 where some or all of the contributed securities do not align with the ETF's investment strategy. The ETF, as part of the same plan, issues creation units (large blocks of ETF shares typically held by institutional intermediaries) to "authorized participants" in exchange for securities that are consistent with the ETF's investment strategy, and then the ETF immediately redeems the creation units with the appreciated securities contributed by the investors. The net effect: investors swap into a different portfolio without paying tax on their gains. The IRS has already acted. Rev. Rul. 2026-20 treats these transactions as taxable sales, so investors who participated may owe tax now.

- **The partnership workaround.** Section 721(a) generally allows investors to contribute assets to a partnership without triggering tax. Some advisors route investors through a partnership first, particularly investors whose holdings are too concentrated to qualify for the Section 351 route, and the partnership then executes the same conversion. Treasury has signaled it is considering guidance that would provide that such transactions do not qualify for nonrecognition treatment.
- **Box spread funds.** Some ETFs use a "box spread," a combination of four options on the same asset that together produce a predictable, interest-like return. Before the profitable options expire, the ETF hands them out in a Section 852(b)(6) redemption and claims it never has to recognize the income. Investors receive what is effectively an interest return, yet no one pays current tax on it. The IRS considers this inconsistent with how investment income should be taxed.
- **Record date strategies.** Some ETFs that invest in other ETFs distribute shares of the underlying ETF pursuant to Section 852(b)(6) just before it pays a dividend, then immediately buy a replacement ETF that tracks the same index. The goal is to avoid dividend income while keeping exactly the same market exposure. Treasury views this as a way to eliminate taxable income with no real change in investment position.
- **Avoiding the RIC income test.** To qualify as a regulated investment company, or RIC (the tax structure behind most mutual funds and ETFs), a fund must earn at least 90% of its income from qualifying sources such as dividends, interest, and securities gains. Some ETFs that hold commodities or digital assets, which produce non-qualifying income, distribute those assets through Section 852(b)(6) redemptions to keep the non-qualifying gains off the books entirely.

Tax-Aware Fund Strategies

The notice also targets strategies used by hedge funds and separately managed accounts, often marketed as "tax-aware" or "tax-advantaged." These strategies exploit technical differences between economically similar products to produce capital gains (taxed at lower rates) paired with ordinary losses (which can offset higher-taxed income such as fees or interest). The notice identifies three:

- **Mixed-character straddles.** A fund takes offsetting long and short positions in the same foreign currency: one through a forward contract, which produces ordinary gain or loss, and one through an exchange-traded futures contract, which produces capital gain or loss. The fund formally designates the pair as an "identified straddle" under Section 1092(a)(2), a provision that lets taxpayers label a pair of offsetting positions for tax purposes. By choosing which leg to close first, the fund claims capital gain on the winner and ordinary loss on the loser.
- **Same-day currency elections with hindsight.** Section 988(a)(1)(B) lets a taxpayer elect capital gain treatment for certain foreign currency contracts, but the election must be made by the end of the day the contract is entered into. Some funds open and close currency forwards on the same day, then elect capital treatment only for the profitable ones after the results are known. The IRS views this as using hindsight to cherry-pick favorable treatment.
- **Selective swap terminations.** A fund enters into multiple short-term swap agreements (technically, "notional principal contracts," or NPCs). When a swap is profitable, the fund terminates it early and treats the payment as capital gain under Section 1234A, which generally treats payments for ending a financial contract as capital. When a swap is losing money, the fund holds it to maturity and claims an ordinary loss. The result is capital gains and ordinary losses from economically identical instruments.

THE RETROACTIVITY RISK

This is not just about future deals. The notice warns that new guidance could apply to transactions that have already closed, citing Section 7805(b)(3), which gives Treasury authority to make new tax rules apply to past transactions when needed to prevent abuse. The IRS has also made clear it may challenge these strategies on audit under current law, without waiting for new rules. Put simply, funds that have already executed these strategies are exposed today.

WHAT FUND MANAGERS SHOULD DO NOW

- **Assess ETF redemption strategies.** If your fund has used any of the ETF strategies above, especially Section 351 conversions, box spread structures, or record date strategies, consult tax counsel immediately. Rev. Rul. 2026-20 has already changed the rules for conversion transactions.
- **Reassess tax-aware funds.** If you manage or invest in a tax-aware fund that uses currency straddles, same-day currency elections, or selective swap terminations, recognize that these strategies are now on the government's radar.
- **Review investor communications.** Revisit marketing materials and investor communications that describe tax benefits from these strategies. Claims about tax efficiency may need to be updated or qualified.
- **Know what is not targeted.** The notice does not target conventional ETF operations. Standard creation and redemption activity, ordinary tax-loss harvesting in equity portfolios, and properly structured ETF launches are not affected. But the government is redrawing the line between "conventional" and "aggressive."

COMMENT DEADLINE

Treasury is accepting public comments through October 28, 2026. You can submit comments electronically at Regulations.gov (search IRS-2026-1255) or by mail. Fund managers and industry groups that believe the notice is too broad, or that want to push for specific safe harbors, should consider commenting directly or coordinating through trade associations before the deadline.

KEY TAKEAWAY

Notice 2026-62 is the strongest signal yet that Treasury and the IRS view certain popular fund tax strategies as abusive. With Rev. Rul. 2026-20 already in effect and retroactive guidance possible, the cost of inaction is rising. Do not wait for final rules to evaluate whether your structures are at risk.

For more information, contact Thomas Gray or visit Troutman Pepper Locke's [Tax Practice Group](#).

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