## Executive Summary

Understanding the tax advantages inherent in Exchange-Traded Funds (“ETF” or “ETFs”) is crucial for investors and advisors seeking to optimize their portfolios. ETFs are widely recognized for their tax efficiency, but many investors face the challenge of transitioning low-basis investments into ETF structures in a tax-efficient manner. The solution lies in utilizing tax-free conversions.

This document provides a comprehensive overview of ETF taxation, with a specific focus on Section 351 tax-free conversions, tailored for those who are new to ETFs. There are other types of tax-free conversions, which we do not discuss in this document, however, the generic processes and outcomes are very similar.

Authored by a distinguished team including Dr. Wesley Gray, Patrick Cleary, Sean Hegarty, CPA, and Bob Elwood Esq., a seasoned tax attorney with extensive expertise in ETF taxation and Section 351 conversions, this document draws on their collective experience and insights. The ETF Architect team is committed to equipping investors with the knowledge necessary to effectively navigate the complexities of ETF taxation and operations.

For further discussion or to explore how these strategies can be applied to your investments, please contact Patrick Cleary or Dr. Wesley Gray via this link or visit our website.

By leveraging these insights, investors can take proactive steps towards maximizing their investment returns while minimizing tax liabilities.

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## Disclosures

The internal notes contained herein are intended solely for the recipient's use and are confidential. These materials have been prepared with the assistance of tax counsel at Practus and are designed to address common inquiries from advisors and investors regarding Section 351 transactions.

Tax Advisory Disclaimer: Neither ETF Architect nor its affiliates provide tax advice. In compliance with IRS Circular 230, we wish to inform you that any tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any matters discussed herein. We strongly advise that you consult an independent tax advisor to assess your specific circumstances.

Estate Planning Notice: The information included in this communication is not intended as a substitute for comprehensive estate planning and does not constitute legal or estate advice. It serves only as a preliminary outline of how tax-free conversions operate. For detailed guidance, we recommend consulting your legal counsel.

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## Why Invest Capital via the ETF Structure?

Below is a brief overview of the potential advantages of an ETF structure, with an emphasis on both non-tax related and tax related benefits.

1. Why an ETF?

    a. Non-tax benefits: There are numerous non-tax benefits for an ETF:

i). Transparency: In most cases, the public can see what assets an ETF is holding on a day-to-day basis. Due to this transparency, there are numerous 3rd party journalists and analysis services that can provide in-depth insights into ETFs, which generates investor confidence and goodwill for the ETF wrapper.

ii). Liquidity: ETF shares are bought and sold during the day while the markets are open. This means that ETF investors know almost instantaneously how much they paid to buy shares and how much they received after selling. It also means that an investor can exit the fund during the trading day, instead of waiting for a redemption to take place at the end of the day after the markets for the fund's underlying assets have closed. Particularly during times of volatility, this can be a considerable benefit over mutual funds; when net asset value is calculated only at the end of each day, and redemptions are processed at that net asset value, then shareholders are subject to the trading activity that follows their exit decision.

iii). Trading: An ETF investor can easily use trading techniques such as limit orders, stop-limit orders, short sales, and buying shares on margin. SMA investors, private fund investors, and mutual fund investors cannot.

iv). Fees: ETFs typically offer lower fees than comparable SMAs, private funds, and mutual funds, which is good news. In general, the lower the cost of investing in a fund, the higher the expected return for that fund.

v). Scale: In our experience, SMAs often create more compliance risk and operational issues than operating a single ETF. This reality is contrary to the expectations of most advisors. In an SMA platform, an advisor must manage tens, if not hundreds or thousands of separate client accounts. This oversight requires significant investment in additional hardware, software, compliance support and staff to perform such nuanced oversight. However, if an advisor were to transition to a handful of strategies that are offered via an ETF, they may have more streamlined client reporting, trading systems, portfolio management, and compliance oversight, delivering increased efficiencies.

vi). Access to Complex Investments: ETFs can more easily access complex instruments that are difficult or even impossible to obtain on an SMA platform. For example, certain derivatives, foreign securities, or futures may not easily fit within an SMA setting. However, such investments are quite routine in the ETF space. Not only does this open architecture provide new investment types for an advisor's clients but it also is easier for an advisor to properly maintain a desired target allocation. This benefit is a result of the scale advantages stemming from a single ETF versus hundreds of smaller SMAs.

vii). A Larger Universe of Possible Investors: Porting a strategy into an ETF wrapper opens up the possibility for additional investors to identify and recognize an advisor's investment offering(s). Serving as an advisor to an ETF, which is traded on a national exchange, carries a level of institutional sophistication that can increase brand awareness. We have seen advisors broaden their reach not only with retail investors directly, but also with financial advisors seeking model portfolios.

It is important to note though that with the increased opportunity for attention comes the potential for increased scrutiny. SMA performance is not available on all major brokerage platforms, with minute-by-minute updates. ETF performance is. For some advisors, such openness is an exciting new proposition. For others, it can come as a bit of a shock. In addition, the advisor eliminates a myriad of positions in a client's account and replaces it with a single holding. While the tax benefits are tremendous (see below) and "look-through" reporting mitigates this issue, there is certainly an educational requirement to help clients understand their assets are not merely a "single ETF".

b. Tax Advantages. ETFs also have large tax advantages over SMAs, private funds, and open-end mutual funds.

Perhaps the greatest advantage is a structural one. Generally, holding an ETF in a taxable account will generate a smaller tax liability than if the investor held a similarly structured SMA, private fund, or mutual fund in the same account (apart from a tax-advantaged account like an IRA, of course).

Most mutual funds and ETFs are taxed as regulated investment companies ("RICs"). When an investor buys and holds a mutual fund or ETF shares, the investor will owe taxes each year on any dividend or income distributions received. An investor may also have to pay taxes each year on their share of the mutual fund's or the ETF's net capital gains — even if the mutual fund or ETF has had a negative return and the investor has not sold any shares. Why? The law requires mutual funds and ETFs to distribute any net capital gains on the sale of portfolio securities to shareholders. Fund shareholders expect gains and losses will be realized and recognized when a manager implements portfolio changes in the mutual fund, however, these gains are also incurred because of mutual fund flows (e.g., investors entering and leaving the fund). When shareholder activity is high, cash needs to be generated and allocated to maintain investment weights. This cash generation can generate capital gains. Stated differently, when a mutual fund shareholder redeems shares, the mutual fund manager must sell securities to raise cash to pay the redemption proceeds. The sale of securities at a gain creates capital gains for the shareholders, including those who may have an unrealized loss on the overall mutual fund investment.

In contrast, when an individual investor wants to sell ETF shares, he simply sells them to another investor over the exchange, as he would any stock. No muss, no fuss, no capital gains transaction for the ETF. ETFs are typically more tax efficient in this regard than mutual funds because an ETF manager accommodates investment inflows and outflows by creating or redeeming in-kind "creation units," which are baskets of assets that approximate the entirety of the ETF portfolio. Creation units are managed by authorized participants (APs); as a result, the investor is usually not exposed to capital gains on any individual security in the underlying structure.

When APs redeem shares, the ETF does not typically sell stocks to pay the AP in cash. Rather, the issuer simply pays the AP in kind — delivering the underlying holdings of the ETF itself. No sale means no capital gains 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") (all section references are to the Code). But it gets even better: The ETF issuer can choose which shares to give to the AP, meaning the ETF can transfer the shares with the lowest possible tax basis. This ability to select tax lots for redemption reduces the fund's tax burden and ultimately results in higher after-tax returns for investors. The ETF tax advantage goes even further when the create/redeem process is used to rebalance an ETF portfolio. The details are complex, but the outcome is clear: ETFs often have NO capital gain distributions, regardless of the ETF's turnover. This structural difference is a huge advantage over mutual funds, hedge funds, and SMAs.

Finally, another smaller, but important tax advantage of the ETF wrapper is the ability to make advisory fees tax deductible. Within an ETF, the advisor's management fee is deducted directly from fund assets and, as a result, is accounted for when calculating an individual investor's gain or loss. This tax savings contrasts with an SMA account, where the fee is generally collected outside the specific investments and cannot be claimed as a tax deduction.

## How to Convert, Tax-Free, SMA assets into an ETF

We summarize the key tax and securities law issues associated with converting separately managed accounts ("SMAs") into an ETF (the process is very similar for converting private funds into ETFs).

There are several logistical factors that need to 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 success of the ETF after the conversion is completed.

i). Gaining Client Permission: Before converting to an ETF, current investors within the SMA will need to provide permission for the conversion to happen, which is typically obtained via client signature. This letter will inform the recipient of an impending action (the conversion) and give them a specified time frame to respond if they would like to participate. This process combines education with fiduciary analysis by the Advisor.

ii). Recordkeeping: Before converting an SMA into an ETF, accurate recordkeeping of the SMA is necessary. This means logging the cost basis and purchase date of all positions in every client account. This process is necessary because even though all assets will be contributed in-kind to the ETF, current clients will need to 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 a taxable event, maintaining accurate records before conversion is essential to ensure that the ETF receives and assumes accurate cost basis information for the securities received, and the client receives the ETF at the appropriate cost basis, and can accurately realize capital gains or losses when they sell ETF shares going forward.

iii). Dealing with Custodians and Similar Parties: Depending on who acts as the present custodian for the securities transferred, or if there are multiple custodians involved, the in-kind transfers can be a time-consuming task for the advisor and the custodians. Lead time may be required.

iv). Sufficient AUM: The advisor should consider whether the strategy has a sufficient level of assets before beginning the conversion process. While converting into an ETF does provide the benefit of wider access to the strategy, it is highly unlikely to draw in millions in new money overnight. Additionally, start-up costs for a tax-free conversion are higher than start-up costs for a traditional ETF launch.[1] While each platform will have their own specific guidelines, we recommend $50+ million as a good benchmark to use when considering what asset minimum makes a 351 transaction economically feasible.

v). Alignment with Go-Forward Prospectus: The advisor, in concert with ETF Architect and tax counsel, will evaluate proposed securities to be transferred against the draft prospectus for the ETF that will "receive" the securities. It is essential to evaluate individual securities on a case-by-case basis. Securities that are clearly NOT aligned with the prospectus should NOT be included (for example, a long-only equity fund should not accept foreign bonds, as they have no place in the go-forward strategy). Typically, 351 conversions follow a two-step process whereby indicative portfolios are confirmed, then final portfolio approval is granted. Please see: "What Can You Contribute in a 351 Transaction?" below.

1) How does an SMA to ETF Conversion Take Place?

The individual SMA investors (collectively, the "Transferors") will contribute securities to a newly formed ETF (the "ETF") in exchange for shares of the ETF (the "Proposed Transaction").

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

There are primarily four things to keep in mind as we consider the Proposed Transaction:

i). Some special rules applicable to transfers to investment companies,

[1] Generically speaking, tax-free conversion startup costs are around $100,000; whereas normal ETF startup costs are approximately $50,000.

ii). The requirement that the assets being transferred are adequately diversified,

iii). The requirement for the Transferors to have 80% control immediately after the transfer(s), and

iv). The need to have a “plan”.

a. Special Rules for Transfers to Investment Companies. Section 351(e) provides that a transfer to an investment company (such as the ETF in the Proposed Transaction) does not qualify for this nonrecognition treatment. To make matters worse, Section 351(e)(1)(B)(iv) states that any interest in a regulated investment company (such as the ETF) is treated as an investment company. Fortunately for our purposes, Section 351(e) also provides that the IRS may prescribe regulations that permit transfers to investment companies to be non-taxable.

Under Treas. Reg. Section 1.351-1(c)(6), portfolios of stocks and securities that are already diversified are not covered by Section 351(e) and 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. As noted below, since the expectation is that the Transferors will satisfy the diversification test, the Proposed Transaction should qualify for the special requirements applicable to transfers to an investment company.

b. 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:

i). Not more than 25 percent of the value of the total assets of the portfolio of the securities each Transferor will be contributing can be the stock and securities of any one issuer. In other words, the biggest position cannot be more than 25% of the total portfolio being contributed.

ii). Not more than 50 percent of the value of such total assets is invested in the stock and securities of 5 or fewer issuers. As a practical matter, this means that each Transferor would need 11 or more positions to transfer (but we need to comply with registered investment company standards as an ETF, which are slightly more stringent, i.e., we are talking 15-20+ issuers).

iii). In determining total assets, you exclude cash and cash items (including receivables), Government securities, and assets acquired (through incurring indebtedness or otherwise) for purposes of meeting the requirements of satisfying the 25% or 50% test.

iv). For purposes of these rules, all members of an affiliated group of corporations are treated as one issuer. This usually only comes up occasionally in connection with things like tracking stocks and multiple share class situations.

v). For purposes of these rules, if a Transferor holds stock in a regulated investment company, a real estate investment trust, or an investment company which meets certain requirements, then the Transferor is treated as holding the proportionate share of the assets held by such company or trust. Practically speaking, ETFs are assessed on a "look-through" basis, meaning their underlying holdings are analyzed against the 25% and 50% tests. For example, SPY is not a single security holding, but rather hundreds of individual securities that easily pass the 25% and 50% tests.

c. "Control". A transfer of assets by one or more parties solely in exchange for the stock of a registered investment company (a "RIC") (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. Control for this purpose is the ownership of stock possessing 80% of the voting power of all shares of voting stock, and 80% of the number of shares of all classes of nonvoting stock. No historic connection or relationship need to exist among the transferors for them to be treated as a "group" of transferors whose interests can be aggregated for purposes of determining whether the required 80% control exists.

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, we should have no trouble with the "control" requirement. However, we should point out that 351 conversions are effectively a "one-time" contribution event and are not continuous subscription type vehicles, where post-conversion, investors are able to contribute tax-free into the newly formed ETF.

d. "Plan". The way all these things interact with one another shows the importance of having an explicit written plan so that all the requirements can be satisfied, including the "control" requirement. We have a draft of a written plan for every proposed transaction.

e. Tax Consequences for 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.

f. Tax Consequences for the Investors. The Investors will have no taxable gain or loss. The Investors will have a carryover basis and carryover holding period in the ETF shares that corresponds to the basis and holding period of the assets transferred.

g. Tax Opinion. A formal tax opinion is provided and can be relied upon by all 351 contributors.

## Who Can Contribute to a 351 Transaction?

1. LP (version one). We can easily convert an existing LP into an ETF.

2. LP (version two). What if a wealth manager has a client that is an LP that owns an SMA managed by the wealth manager? That will NOT pose a problem, but we need to do some additional analysis. Specifically, we would want to look through the LP to its owners (and if that LP is in turn owned by another LP or other pass-through, we keep working our way up the chain). In our experience, once you do the look-through analysis regarding an LP that owns an SMA, you nearly always get a good answer (e.g., you discover that the LP is owned by four individuals). But you might find that an owner of the LP is a C corporation (see below), which would be a potentially bad answer.

3. Foundations and tax-exempts. These are nearly always acceptable transferors. In some cases, foundations and tax-exempts don't care whether the transfer is a good 351 or not because they are not subject to tax. In the somewhat less common situations in which a foundation or a tax-exempt might care, we can nearly always find a way to make this work for everyone. The only reason we flagged this is that we will usually want to ask some questions just to be sure this is a no harm/no foul situation.

4. Trusts. The situation with trusts is very similar to the situation with LPs described above, but in practice you virtually always get good answers. The typical trust is either

a taxpaying entity itself (generally a good transferor) or a pass-through where the owner/beneficiary is a good transferor (such as an individual). Although there is some “kicking the tires” needed with trusts, so far, in our experience in 100% of the cases the trust or its beneficiaries turned out to be good transferors.

5. Corporations. If property owned by a “C corporation” becomes the property of a RIC or REIT (the “converted property”) in a “conversion transaction,” then a so-called “built-in gains tax” will apply…unless the C corporation elects deemed sale treatment regarding the conversion transaction. Both of these are unattractive options (not impossible, but sufficiently undesirable that they present big challenges). We can often make things work if the transferor is an S corporation, but we would need to do some additional analysis.

6. ERISA accounts. ERISA assets cannot be transferred on an in-kind basis without a Department of Labor exemption. Possible solution: convert these assets to cash and contribute the cash. The ERISA account should not be subject to tax, so the sale of assets should not generate any tax.

## What Can you contribute in a 351 Transaction?

351 Contributions are part "art" and part science. We have walked through the quantitative tests described above for diversification. That said, diversification is but a single part of the equation. As an advisor launching a new ETF, the assets transferred need to reflect the general guidelines of the prospectus itself. Specifically, transferred securities must represent what the prospectus describes. For example, a long-only US equity strategy should not hold foreign bonds. An emerging markets strategy should not hold crypto, etc. Of course, prospectus documents, particularly for active funds, grant the portfolio manager flexibility to hold various asset classes; however, common sense must prevail to ensure a successful 351 transaction. Below is a summary of common asset classes with summary notes. *For removal of doubt, the overarching litmus test for accepting any 351 asset is to evaluate that asset against the prospectus in question.*

1. US Equities / ADRs. Yes. Ensure names align with the fund strategy and avoid illiquid and OTC securities.

2. Foreign Equities / GDRs. Yes. Ensure names align with fund strategy. Ensure the market/country where local names are held allows in-kind transfers.

3. Mutual Funds. No because mutual funds cannot be traded in-kind, which means they are not good assets to transfer in a 351 transaction.

4. US ETFs. Yes. ETFs are treated as "look-through" for diversification purposes, so the underlying names within the ETF are combined with the overall portfolio. For example, a 351 contribution with 10% SPY is really a 351 contribution with SPY's holdings. See "Cash" and "Government Bonds" below for the impact to look-through analysis.

5. Foreign ETFs. This is possible, but more operational legwork required. Must be redeemable in-kind. "Foreign" ETFs in this context mean US traded ETFs that hold foreign securities.

6. Closed End Funds. Possibly if publicly traded and redeemable in-kind.

7. Fixed Income ETFs. Yes. Keep in mind, the fixed income needs to align with the broader strategy. For example, if a small amount of the overall portfolio and used as a cash substitute, yes. Conversely, if a large portion of a portfolio being used to launch an "all-equity" ETF, then no.

8. Cash. Yes, but does not count for diversification purposes. We recommend holding a cash yield equivalent, or better yet, converting the cash to equities for proper diversification. Typically, cash can be deployed in advance to improve diversification results, and thus, we do not recommend large cash transfers within a 351.

9. Government Bonds. Yes, but does not count for diversification purposes (similar to cash). We recommend holding a cash yield equivalent, or better yet, convert to equities for proper diversification.

10. Spot Crypto Directly. No. ETFs, currently, cannot hold spot crypto unless it is a standalone Grantor Trust regulated by the Securities Act of 1933 (e.g., GBTC and ARKB).

11. Spot Crypto within an ETF (e.g., GBTC). Yes, so long as the contribution is aligned with the overall fund strategy. Keep in mind, this only applies to a relatively small portion of the portfolio. Bad income producing securities (e.g., grantor trusts that are common for spot bitcoin funds) require more operational support (and may be cost prohibitive).

12. Commodity ETFs (GLD). Yes, so long as the contribution is aligned with overall fund strategy. Keep in mind, this only applies to a relatively small portion of the portfolio. Bad income producing securities require more operational support (and may be cost prohibitive).

13. MLPs/Public Partnerships. Yes, so long as the contribution is aligned with overall fund strategy. Keep in mind, this only applies to a relatively small portion of the portfolio. Bad income producing securities require more operational support (and may be cost prohibitive).

14. Private stocks/REITs. No. The equities must be redeemable in-kind.

15. Restricted Stock Units. No. The equities must be redeemable in-kind.

16. Hedge Funds. Possibly, but requires a complete transfer of the assets, alignment with the prospectus, and derivatives exposure + leverage need to be unwound.