Part I

Section 1001. -- Determination of Amount of and Recognition of Gain or Loss

26 CFR 1.1001-1: Computation of gain or loss.
(Also §§ 351, 852; 1.351-1)

Rev. Rul. 2026-20

ISSUE

Should a transfer of securities to a newly formed exchange traded fund that is intended to qualify as an exchange to which § 351 of the Internal Revenue Code (Code)[1] applies fail to qualify as such if, as part of the same plan, some or all of the transferred securities are distributed pursuant to § 852(b)(6) in redemption of shares held by an "authorized participant"?

FACTS

As part of a plan, an investor (Investor) transfers a portfolio of securities to a newly formed exchange traded fund (ETF). For Federal income tax purposes, ETF is a

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[1] Unless otherwise provided, all "Section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

corporation that intends to qualify as a regulated investment company (RIC) under § 851 and to meet the requirements to be taxed under subchapter M of the Code. At the time of Investor's transfer to ETF the securities are appreciated, and the transferred portfolio is diversified within the meaning of § 1.351-1(c).

Pursuant to the same plan that includes the transfer of securities by Investor to ETF, the following two transactions take place. First, ETF issues shares to a person serving as an "authorized participant" (AP) in exchange for securities that are consistent with the ETF's investment thesis or cash that ETF intends to use to acquire such securities. Second, and shortly thereafter, ETF redeems those shares, in a transaction intended to qualify under § 852(b)(6), in exchange for securities transferred to ETF by Investor. Upon completion of the planned transactions, ETF holds a portfolio of securities that is consistent with its investment thesis and materially different from the portfolio transferred by Investor.

LAW AND ANALYSIS

A RIC, as defined in § 851, is a domestic corporation for federal income tax purposes that meets requirements specified in § 851. A RIC that meets the requirements of § 852 is taxed under part I of subchapter M of chapter 1 of the Code (subchapter M). Taxation of RICs and their shareholders under part I of subchapter M is generally more favorable than taxation of non-RIC corporations subject to subchapter C of chapter 1 of the Code (subchapter C). Like other corporations subject to subchapter C, a RIC generally must recognize gain upon a distribution of appreciated property under § 311(b). However, § 852(b)(6) provides that § 311(b) shall not apply to certain RIC distributions. Specifically, § 311(b) does not apply to any distribution by a RIC to which part I of subchapter M applies, “if such distribution is in redemption of its stock upon the demand of the shareholder.”

Section 351 provides that 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 § 368(c)) of the corporation. “[T]he purpose of [§ 351] [is] to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really ‘cashed in’ on the theoretical gain, or closed out a losing venture.” *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488 (1st Cir. 1940).

Under generally applicable principles of law, such as the substance over form and step-transaction doctrines, an intermediary’s transitory ownership of property may be disregarded for Federal income tax purposes and the transaction recharacterized in accordance with its substance. *See generally Stewart v. Commissioner*, 714 F.2d 977, 987 (9th Cir. 1983) (observing that the purpose of the substance over form doctrine is to deny legal effect to transactions that comply with the formal requirements of a statute but violate the purpose of the statute). In this regard, transactions effectuated as part of a single integrated plan may be recharacterized to ensure that “[a] given result at the end of a straight path is not made a different result because reached by following a devious path.” *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938). For example, in *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945), the

Supreme Court stated that a “sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.”

Courts and the Internal Revenue Service have found that contributions of property to a corporation followed by a distribution of the contributed property or a redemption of shares in exchange for the contributed property may be recharacterized. For example, in *Kuper v. Commissioner*, 533 F.2d 152 (5th Cir. 1976), shareholders of one corporation (KE) contributed all shares in KE to another corporation (KV) owned by the same shareholders. On the following day, KV distributed the KE stock to one shareholder in complete redemption of its interest in KV. The Fifth Circuit held that, where shareholders of one corporation (KE) contributed all shares in KE to another corporation (KV) owned by the same shareholders and, on the following day, KV distributed the KE stock to one shareholder in complete redemption of its interest in KV, (i) the contributing shareholders who continued to own shares of KV would be treated as engaging in a taxable disposition of their KE shares with the shareholder being redeemed, and (ii) the redeemed shareholder would be treated as engaging in a taxable disposition of its KV shares with the shareholders who retained their KV shares. Rev. Rul. 71-336, 1971-2 C.B. 299, similarly concludes that where, pursuant to a pre-arranged plan, a group of shareholders contributes, appreciated stock in a corporation (Y) to another corporation (X) and, shortly thereafter, X redeems its stock held by another historical X shareholder in exchange for the appreciated Y stock transferred by the group of shareholders, the transactions should be recharacterized as a taxable stock-for-stock exchange among the shareholders.

Similarly, pre-acquisition distributions have been recharacterized as sale proceeds in situations in which the distribution or redemption has not aligned with the economic reality of the transaction. *See, e.g., Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970) (holding that the distribution of a promissory note by a subsidiary corporation to its parent was in substance part of the purchase price paid by a third party to the parent for the subsidiary's stock); Rev. Rul. 75-360, 1975-2 C.B. 110 (integrating a cash redemption of target preferred stock with an acquisition of common stock for common stock as a transaction that does not qualify as a reorganization under § 368(a)(1)(B) because the acquisition is not solely for voting stock).

In the situation at hand, the transactions undertaken as part of the plan were designed to enable Investor to exchange Investor's appreciated portfolio of securities for a materially different portfolio that aligns with the ETF's investment thesis without recognizing any built-in gains in those securities, and ETF was merely a conduit through which securities transferred from Investor to AP pursuant to the plan. Based on the foregoing, Investor is treated as having disposed of these securities for other property differing materially in kind or extent from that which Investor transferred to ETF.

HOLDING

The transfer of securities by Investor to ETF is recharacterized to reflect the substance of the transactions carried out pursuant to the plan. Accordingly, Investor is treated as undertaking a taxable exchange under § 1001 with AP of the securities contributed to ETF by Investor that are used by ETF to redeem AP. The result would be the same if there were multiple investors engaging in the transaction.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 71-336, 1971-2 C.B. 299, is amplified; Rev. Rul. 75-447, 1975-2 C.B. 13, and Rev. Rul. 88-32, 1988-1 C.B. 833, are distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, call (202) 317-3181 (not a toll-free call).