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Tax Section

VIRTUAL 2026 FALL TAX MEETING

#26TaxFall

Tax Planning Strategies in the Investment Funds & Financial Products Space

Investment Management

October 5-9 Online

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The Panel

Moderator: Vadim Novik, Partner, Fried Frank

Panelists: Rebecca Lee, Partner, Dechert LLP

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The Panel



Mark Leeds (mark.leeds@pillsburylaw.com; (212) 858-1080) is a tax partner at the law firm of Pillsbury Winthrop. Mark's professional practice focuses on the tax consequences of a variety of cross-border capital markets products and strategies, including over-the-counter derivative transactions, prediction market trading, digital asset transactions, swaps, tax-exempt derivatives and working with credit funds, offshore insurance companies and hedge funds. Mark also does extensive work in cross-border US – Puerto Rico tax planning. Prior to joining Pillsbury, Mark was a partner at another International law firm, served as a Managing Director at Deutsche Bank, general counsel of a credit derivative company and, prior to that, Mark was a partner at Deloitte, where he led the Capital Markets Tax Practice. Mark began his legal practice at Skadden Arps and then worked at Weil Gotshal.

The Panel



Vadim Novik is a recognized leader in advising investment funds, asset managers, trading firms, banks, high net worth individuals, and other clients on a broad range of complex tax issues, with a focus on cross-border structuring and financial products—including credit, derivatives, trading strategies, structured notes, “tax aware” investments, commodities, risk transfers and securitizations.

Vadim is known for his ability to integrate tax considerations into the broader commercial and economic objectives of a transaction, helping clients not only understand the tax consequences of their deals, but proactively structure transactions in a tax-efficient manner.

Vadim is a thought leader in the industry. He frequently speaks at industry conferences, including PLI, the New York State Bar Association, the American Bar Association, and the Wall Street Tax Association.

Certain Prediction Market Tax Considerations

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Background on Prediction Market Contracts

- Contracts are always binary (yes or no)
- Digital pay-out (\$1 or zero)
- Kalshi & Polymarket USA are regulated by the CFTC
- Sports contracts dominate the markets (90% by volume)

Prediction Market Contracts as 1256 Contracts

- Non-equity options must be listed options
 - Not an equity option
 - Traded on a qualified board or exchange
 - CFTC Regulation of Kalshi & Polymarket should meet this requirement
 - Must be an option
- Options for tax purposes:
 - Right (but not an obligation) to buy or sell
 - Specified property
 - On or before a specified date
 - For consideration (Option premium)

Prediction Market Contracts as Gaming Contracts

- Gaming losses are limited to 90% of gaming winnings
 - Session rule allows netting of gains and losses incurred in a single session
- Gaming income is ordinary for US taxpayers
- Tax Code Section 4421 imposes an excise tax on wagers
 - Treas. Reg. § 44.4421-1(c)(3) defines a “contest” as any type of contest “involving speed, skill, endurance, popularity, politics, strength, appearances, etc., such as a general or primary election, the outcome of a nominating convention, a dance marathon, a log-rolling, wood-chopping, weight-lifting, corn-husking, beauty contest, etc.” In TAM 200417004, the IRS concluded that the definition of “wagering” in Section 165(d) is consistent with the definition in Section 4421..
- Source issue for Non-US taxpayers trading contracts on US exchanges

Prediction Market Trading by Non-US Investors

- US funds with offshore investors and non-US taxpayers are increasingly entering into contracts on prediction markets regulated by the Commodities Futures Trading Commission (the CTFC)
- If the prediction market contracts are gaming contracts and not earned in a US trade or business, then gross gains from these contracts could be treated as US-source income. Barba v. United States, 2 Ct. Cl. 674 (1983)
- When the session rule applies, losses incurred in the same session can be netted against gains. Code § 165(d); Park v. Comm'r (2013)
- If the transaction is initiated from outside of the US, the income may be treated as foreign-source. *IRS Instructions for Forms W-2G & 5754*.
- Certain tax treaties exempt gaming income earned in the US from US withholding tax

Prediction Market Contracts as Non-Equity Options

- Contractual right to payment is determined by uncertain future event
- Upfront consideration is not in-the-money
- Specified payment functions as the settlement amount
- No transfer of indices of ownership of the underlying index
- After payment of upfront premium, there are no further actions to be taken
- Binary payout should not preclude option treatment. Binary options are recognized as options
- Writer (exchange) is bound at inception
- CFTC treatment as a binary swaps should not dictate Section 1256 treatment
- Modest duration

Prediction Market Contracts as Commodities

- Event contracts listed on “designated contract markets” are regulated by the CFTC as “swaps,” but the CFTC views them as referencing “excluded commodities.”
- Code § 864(b)(2)(B)(i) and (ii) contain safe harbors for foreign persons engaged in trading commodities (1) through an independent agent or (2) for their own account, respectively. Requirements to qualify include:
- “Commodity”
 - “Of a kind customarily dealt on an organized commodity exchange”
 - “Transactions . . . of a kind customarily consummated at such a place”
 - Rev. Rul. 73-158 offers support for concluding that the IRS will defer to the CFTC as to what constitutes a “commodity” for U.S. federal income tax purposes.

Revenue Ruling 2026-20: ETF Conversion Transactions/Roll-Ups for Holders of Appreciated Stock Portfolios

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ETF Roll-Ups

- Investment managers have solicited holders of “diversified” appreciated stock portfolios to contribute the diversified portfolio to an ETF (closed-end mutual fund) in a Section 351 transaction
- Section 351 treatment is dependent upon the transferors not achieving “diversification.”
- Diversification does occur if contributed portfolio satisfies 25% & 50% tests in Code § 368(a)(2)(F)
 - Not more than 25% of the value of total assets is in the stock & securities of any single issuer
 - Not more than 50% of value is in stock & securities of 5 or fewer issuers

ETF Then Rationalizes its Holdings Using Code § 852(b)(6)

- Code § 856(b)(6) allows a mutual fund to distribute appreciated securities to a stockholder in redemption of its stock without recognizing gain on the distribution of the appreciated securities.
- Securities law rules limit the persons to whom distributions of securities can be made to “authorized participants,” that is, market makers in the stock of the mutual fund
- The sponsor purchases stock in the newly-formed ETF for cash.
- Shortly following the stock purchase by the sponsor, the newly-created ETF distributes stocks that are inconsistent with investment strategy to the sponsor in redemption of the shares purchased by the sponsor.
- The ETF uses the cash received in the creation-redemption transaction to purchase stocks & securities consistent with its investment strategy.

IRS Responds to ETF Roll-Ups in Rev. Rul. 2026-20

- Rev. Rul. 2026-20 asserts that the substance of the roll-up and use of Code § 852(b)(6) is a sale of the appreciated securities by the original transferor
 - ETF was a conduit “through which the securities [were] transferred from the Investor to the [Authorized Participant].
Waterman Steamship
- Notice 2026-62: Rev. Rul. 2026-20 does not address when the ETR is seeded with “assets that are consistent with the ETF’s investment thesis and that are intended and expected to be retained by the ETF absent a substantial change in circumstances.”

Notice 2026-62 Addresses New Wave of Tax Alpha Investment Products

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Code § 351 - Partnership Transfers

- Partnership variant on 351/ETF Roll-Up
- Exchange fund contribution (non-diversified portfolio contribution) so Code § 721(a) applies to the transfer
- Partnership then transfers its portfolio to an ETF
- FLP planning likely with respect to partnership interests

Box Spread Transactions

- A “box spread” is a combination of four options on the same underlying asset that together produce a stable time-value-of-money return similar to a short-term interest rate.
- Treasury and IRS described an ETF that enters into box spreads which consist of options that are not section 1256 contracts.
 - Such ETF then distributes the appreciated options to redeeming authorized participants in a redemption transaction that is intended to qualify for nonrecognition under section 852(b)(6).
 - As a result, such ETF avoids recognizing any current income from the box spreads while being able to accrue economic appreciation within the ETF.
 - Shareholders generally recognize capital gain upon a sale or disposition of their shares rather than current ordinary income.
- In some other cases, an ETF may engage in a box spread transaction and also enter into separately offsetting positions that constitute a straddle within the meaning of section 1092(c)(1).

Embedding Box Options Within an ETF Creates Capital Gain Opportunity

- BOXX's strategy utilizes 4 options treated as Section 1256 contracts. The options, taken together, provide a return that is approximately equal to the short-term Treasury rate
- A “bull call spread”
 - BOXX buys call options on the S&P500
 - BOXX then sells call options on the S&P500 with a higher strike price (but same expiration date)
- BOXX then enters into a “bear put spread”
 - BOXX purchases S&P500 put options
 - BOXX sells S&P500 put options with a lower strike price (but, again with the same expiration date)

Example of the BOXX Strategy

- Assume SPY trades at \$51 per share
- Buy an S&P Call Option @ 49 and pay \$329 (in the money by \$200 $((51-49) \times 100 \text{ shares})$)
- Sell an S&P Call Option @ 53 and receive \$123 (out of the money by \$200 $((53-51) \times 200 \text{ shares})$)
- Buy an S&P Put Option @ 53 and pay \$269 (in the money by \$200 $((53-51) \times 200 \text{ shares})$)
- Sell an S&P Put Option @ 49 and receive \$97 (out of the money by \$200 $((51-49) \times 100 \text{ shares})$)
- Total cost = \$378 $(439 - 123 + 269 - 97)$
- Guaranteed Return: \$22 = \$400 $(\$2 \times 200 \text{ shares})$ minus \$378 cost (before commissions).
Return is solely attributable to time value of money.

Some Observations on BOXX's Options

- Although locked-in return is solely attributable to time value of money, it is not a debt instrument
 - There is no debtor and yield is embedded within the options
- All positions are subject to Section 1256, requiring BOXX to use the mark-to-market method of accounting
- Section 1256 treatment also treats all gains and losses as 60% long-term and 40% short-term
- Net result is that BOXX has capital gains and losses (absent rules that would change character)

Certain Box Option ETFs Utilize Creation/Redemptions

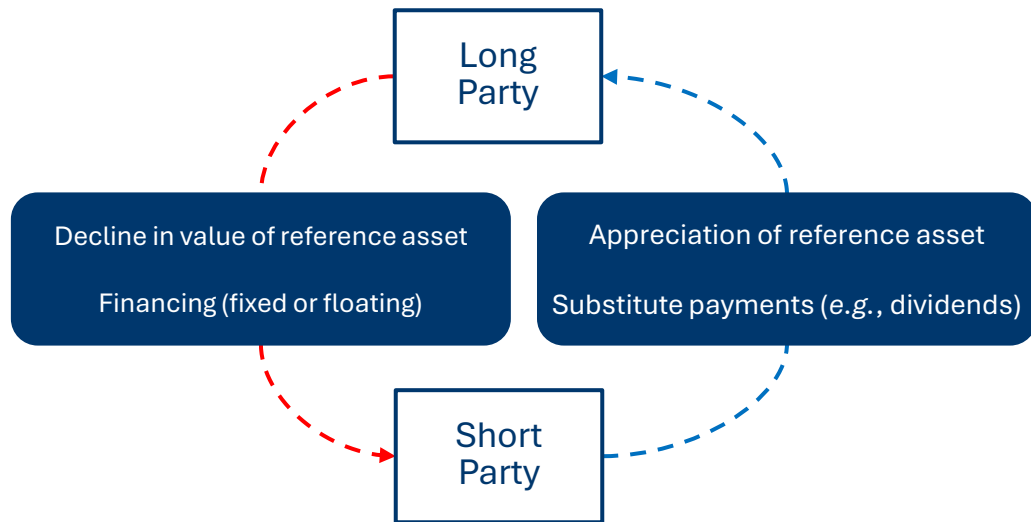
- ETF then distributes appreciated legs of box option strategy to an authorized participant in a transaction protected by Code § 852(b)(6)
- ETF then has no income to distribute to shareholders
- ETF claims that losses inherent in the straddle become deductible because there is no longer an offsetting gain position
- IRS did not weigh in on the loss recognition

Character Conversion and Electivity Strategies

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NPC Basics (asset-based swap)



Definition and Economics

- A notional principal contract (an “NPC”) provides for payments at specified intervals by reference to a specified index and a notional principal amount.
- The long party generally receives appreciation of the reference asset and substitute payments, such as dividend-equivalent economics.
- The short party generally receives decline in value of the reference asset and financing-type payments.
- The instrument can replicate stock, index, currency, rate, or commodity exposure without direct ownership of the reference property.

Treas. Reg. § 1.446-3 Framework

- Periodic payments are recognized over the period to which they relate.
- Nonperiodic payments may be made as initial or final payments, and if final payments may be fixed or contingent. Under the NPC timing rules, nonperiodic payments are required to be recognized over the contract term in a manner that reflects the economic substance of the contract. Proposed 2004 regulations provide rules for accrual of contingent nonperiodic payments at year-end.
- A termination payment is a payment made or received to extinguish or assign all or a proportionate part of a party's remaining rights and obligations under an NPC.
- Scheduled final payments are distinct from payments made to terminate or extinguish the NPC.

NPC and Section 1234A Character Rules

NPC Economics

- Many equity NPCs provide that (i) the long party pays the financing monthly and the short party pays substitute dividends periodically, each of which would be periodic payments under the NPC rules and (ii) a single settlement payment is made at maturity to account for the appreciation or decline in value of the referenced equity, which would be a nonperiodic payment.

Treas. Reg. § 1.446-3

- Periodic payments are generally treated as ordinary income or expense. The accrued portion of a nonperiodic payment is also treated as ordinary income or expense.

Section 1234A

- Section 1234A(1) generally provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer is capital gain or loss.
- Proposed 2004 regulations provide that Treas. Reg. § 1.446-3 termination payments are treated as gain or loss from a termination of the NPC, and that periodic and nonperiodic payments (including a final scheduled payment) do not terminate or cancel a right or obligation for purposes of Section 1234A.
- Consequently, a final nonperiodic payment gives rise to ordinary income or expense while a termination payment gives rise to capital gain or loss if the NPC is a capital asset.

Section 1256 and Section 988 Character Rules

Section 1256

- Section 1256 contracts generally are marked to market at year end.
- The resulting gain or loss generally is treated as 60% long-term and 40% short-term capital gain or loss.
- Section 1256 contracts include regulated futures contracts and certain exchange-traded options.
- Foreign currency forwards are section 1256 contracts and thus marked to market at year end, but their character is governed by Section 988, absent a Section 988(a)(1)(B) election (discussed below).
 - In the case of regulated futures contracts and exchange-traded options linked to foreign currencies, Section 1256 generally governs *both* timing and character (absent an election under Treas. Reg. § 1.988-1(a)(7)(ii) to apply Section 988 to all such contracts).

Section 988

- Foreign exchange gain or loss generally is ordinary, and—in the case of most foreign currency derivatives—all gain or loss is treated as foreign exchange gain or loss.
- Section 988(a)(1)(B) election: A taxpayer may elect capital treatment for foreign currency forward contracts and certain other foreign currency derivatives that are capital assets, but the election generally
 - Must be made by the close of the day the transaction is entered into; and
 - Is not available if the contract is part of a Section 1092(c) straddle.

Straddle Rules and Identified Straddles

General Straddle Rules

- Section 1092 applies when a taxpayer holds offsetting positions in actively traded personal property.
- Positions are offsetting when one position substantially diminishes the risk of loss from another.
- The loss deferral rule generally defers loss to the extent of unrecognized gain in offsetting positions.

Identified Straddles

- If a straddle is properly identified under Section 1092(a)(2), the loss deferral rule described above does not apply.
- Instead, loss recognized with respect to a position that is part of an identified straddle is capitalized into the basis of the offsetting position.

New Tax Court Decision Exposes Tax Trap for Canadian Tax— Exempts with Exposure to US Stocks

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Tax Trap for Tax-Exempt Canadian Investors

- TD Bank maintained a Canadian unit trust that invested, inter alia, in US dividend-paying stocks
- The unit trust had both Canadian taxable & tax-exempt investors
- The South Saskatchewan Community Foundation, a Canadian tax-exempt investor, purchased units in the TD trust & received dividends on US stocks
- The paying agent to the unit trust withheld US tax, at the Treaty rate, on the dividends allocable to the Canadian charity
- The charity sought a refund of the US withholding taxes allocable to the dividends it received

Tax Trap for Tax-Exempt Canadian Investors

- Article XXI(1) of the US – Canada Tax Treaty allows Canadian investors to receive dividend income free from US tax
- Article XXI(3), however, limits the ability of Canadian tax-exempt investors to receive tax-free income earned through investment vehicles only if the investors in the pooled vehicle are limited to tax-exempt investors
- Article IV(6) allows investors in fiscally transparent entities to determine Treaty eligible income at the investor level
- Treas. Reg. § 1.894-1(d) similarly permits a non-US taxpayer to claim Treaty benefits earned through fiscally transparent vehicles

Tax Trap for Tax-Exempt Canadian Investors

- In *SSCF v. US* (Aug. 25, 2026), the Tax Court assumed that if Treaty Article IV(6) and Treasury Regulation § 1.894-1 applied, the Canadian charity would not have been subject to US tax on the dividend income
- The Tax Court also stated that if the charity had received the dividends directly, it would not have been subject to US tax.
- But the court held that the charity could not avail itself of either Article IV(6) or the Treasury Regulation because Article XXI(3) established the exclusive rule for pooled investment vehicle income earned by a Canadian charity

For more information

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Questions?

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