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Tax Section

VIRTUAL 2026 FALL TAX MEETING

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Tax Planning Strategies in the Investment Funds & Financial Products Space

Investment Management

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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 Brown, 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.

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

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 as 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

Certain Prediction Market Tax Considerations for Non-US Investors

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 (213)
- 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 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 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

ETF Roll-Ups for Holders of Appreciated Stock Portfolios

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.

Susquehanna Decision Limits Efficacy of Basket Swap Transactions

70/30 Basket Swaps Generally Are Not Considered Offsetting

- Offsetting positions with respect to stock can (i) limit statutory stock holding period requirements for qualified dividend income and foreign tax credits, (ii) create straddles, (iii) cause constructive sales.
- Treasury Regulation § 1.245-5(c) provides that offsetting positions embedded in financial positions will not be disaggregated & treated as offsetting provided that the offsetting potions are less then 70% of the fair market value of all positions referenced in the financial position.
  - This is referred to as the “substantial overlap” test.
- Even if the substantial overlap position is satisfied, however, an anti-abuse rule can result in a disaggregation of the financial instrument
  - Changes in the value of the financial instrument are “reasonably expected” to the positions held by the taxpayer
  - The principal purpose of the plan is to obtain tax savings significantly in excess of pre-tax profit

The Susquehanna Case

- SIG regularly entered into hedges of its market-making positions as part of the "Firm Hedge."
- A prominent bank approached SIG and suggested implementing the Firm Hedge with a basket swap.
- SIG added 4 Swiss stocks to the basket swap implementing the Firm Hedge and, at the same time, acquired the same amount of the Swiss stocks
- The Swiss stock positions embedded in the basket swap qualified under the "substantial overlap" test to NOT be disaggregated
- SIG made over 200 changes to the Firm Hedge items in the basket swap during the years at issue
- While there was conflicting testimony, the Court estimated that SIG expected 10x more after-tax than pre-tax profits from the holding of the stocks & the basket swap

The Holding of the Susquehanna Case

- The Tax Court held that the basket swap satisfied Treasury Regulation § 1.245-5(c) even though the Firm Hedge positions were regularly traded in and out of the basket
- The Tax Court held for the IRS that the anti-abuse rule prevented SIG from satisfying the holding period to treat dividends on the Swiss stocks as qualified dividend income and withholding taxes paid to Switzerland as creditable foreign tax credits
  - On the virtually tracking leg of the anti-abuse rule, the IRS seemed to look-through the basket swap instead of asking whether the basket swap as a whole virtually tracked the Swiss stock portfolio
  - The IRS held that that the taxpayer's expectation of a 10x after-tax return over its pre-tax return was evidence of a plan to use the basket swap to avoid taxes

For More Information

- Mark Leeds, Partner - (212) 858-1080

Questions?