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Capital Gains Vanish Into ‘Black Holes’ in Latest ETF Tax Trick

Investors are seeding ETFs with appreciated assets, taking advantage of an infamous loophole to wash out taxable gains.

By Justina Lee

(Bloomberg) -- Officially, the Twin Oak Active Opportunities ETF exists to seek “long-term capital appreciation.” Unofficially it has a second, more cunning, purpose.

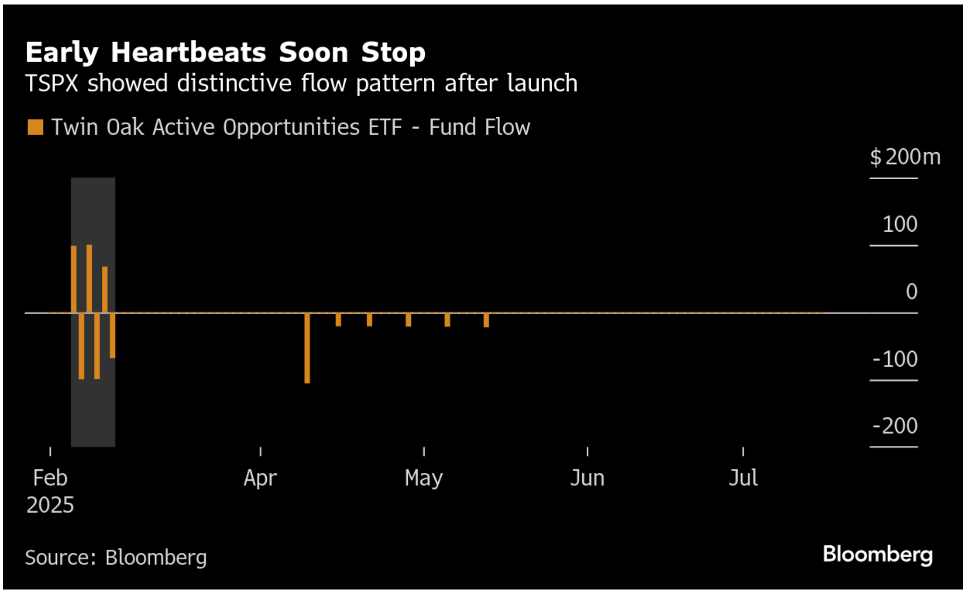
TSPX, to use the fund’s ticker, debuted in February without much marketing. Yet it launched with nearly $450 million in assets and almost immediately received a $99 million inflow — amazing numbers for a virtually unknown ETF.

The day after that big inflow, there was an almost identical outflow. A similar pattern repeated in the next two trading days, and then again in the two days after that. And as all that capital rushed in and out, a change took place within TSPX that offers a vital clue as to its true nature.

Having launched with just five positions — around $245 million across three fixed-income ETFs, a $99 million stake in Snowflake Inc. and $92 million in Datadog Inc. — TSPX swiftly replaced its two equity holdings with a roughly equivalent slice of a simple S&P 500-tracking fund.

Why did TSPX launch with such a large and concentrated portfolio, only to change about 40% of it in the space of a couple of days? Why were there such big flows in and out of an unknown ETF? And why did they abruptly stop?

The answer comes down to tax.



TSPX is one of a breed of exchange-traded funds created via what's known as a 351 conversion. It's a tactic to help rich investors minimize capital gains tax liabilities — one of a plethora of strategies that form Wall Street's flourishing tax-optimization complex.

In a 351, a fund is seeded with appreciated assets before launch so that after listing it can use an infamous ETF industry loophole to rebalance without realizing a taxable gain, usually harnessing artificial flows to do so. While they'll often retain their original strategy afterwards, some — like TSPX — use the process to significantly alter the portfolio without incurring taxes.

It's creative, clever, and completely legal — and although 351 ETFs are not labeled in any way, there are signs they're proliferating.

"The last three years have seen a significant uptake" in 351 conversions, says Robert Elwood, a Truro, Massachusetts-based lawyer at Practus LLP who estimates he has worked on close to 100. "As we've been in a bull market generally for the last 10 years or so, there are a lot of people sitting on built-in gains that would like to change their portfolio."

The wealth management industry's pitch is that ETFs can help do that while minimizing the government's cut — an alluring proposition after a decade in which the S&P 500 tripled. Investors will still owe taxes based on the original purchase price, or basis, of their investments when they sell the ETF shares, but the idea is they get to keep more cash invested and compounding for longer. In short, it's a deferral — or an interest-free loan from the government, as Vanguard Group founder Jack Bogle once put it.

The Twin Oak ETF Company, whose website says it is backed by family offices, declined to comment.

Tax Advantage

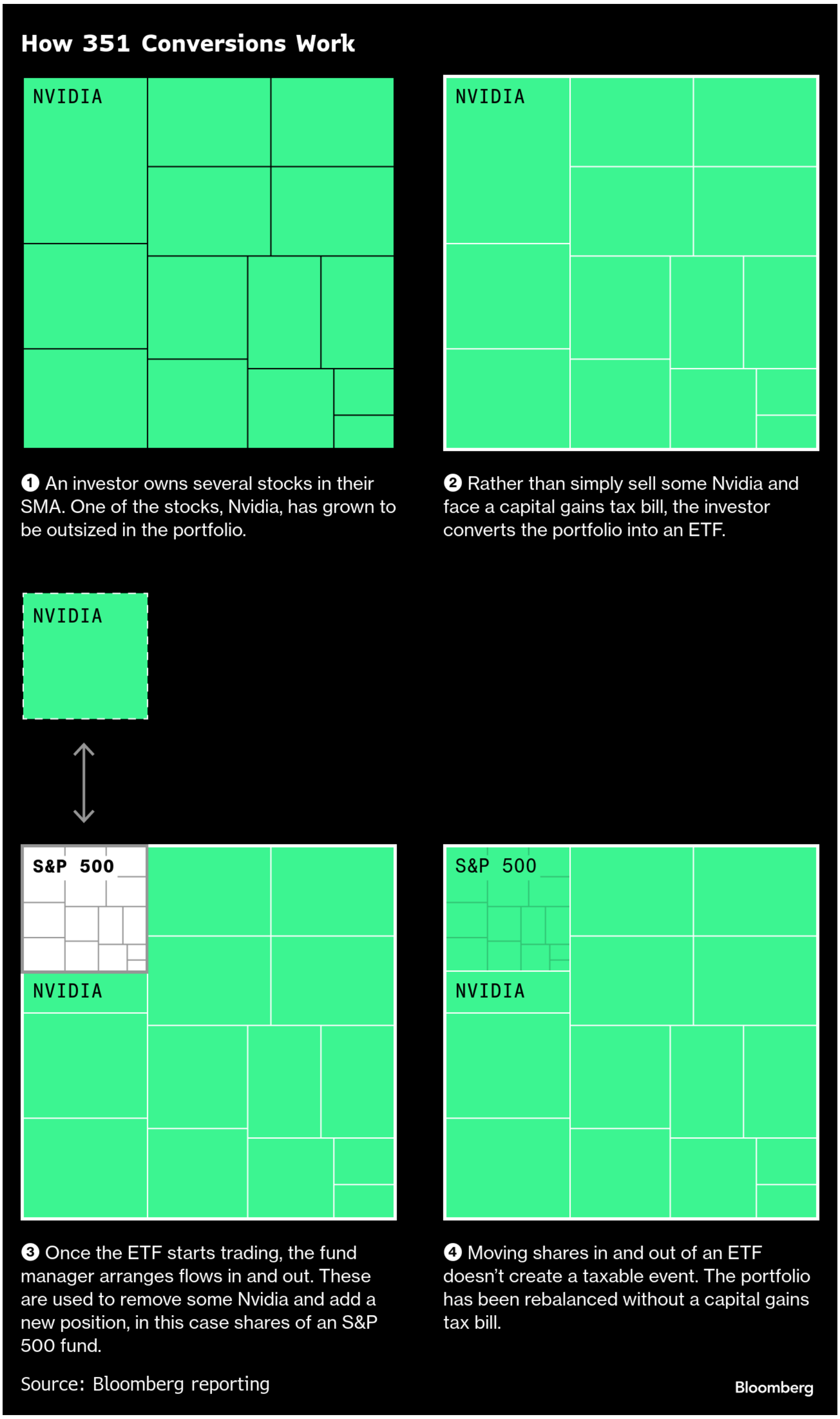
To understand a 351 conversion, imagine an investor who holds 20 positions in their separately managed account, or SMA (a vehicle frequently used by wealthy Americans to own securities directly). One of the holdings is in Nvidia Corp., which has soared nearly 1,000% in the past three years.

"You say, 'Gee, Nvidia's gotten a little bit too rich for my blood, I'd like to get rid of it,'" says Elwood. "The problem you would have is the only way to do it in a separately managed account would be to sell it, recognize some taxable gain."

Under section 351 of the tax code — rules dating back to the 1950s intended to encourage entrepreneurship by letting Americans create new companies with existing assets — the investor can instead form an ETF with the portfolio. Once the ETF is launched they can use flows in and out to rebalance away from Nvidia, replacing it with, say, shares of Apple Inc.

"Your transfer of 20 positions into the ETF is not taxable, and then the substitution of taking Nvidia out and putting Apple in are both non-taxable as well," Elwood says.

That's thanks to the great tax advantage of an ETF, where assets are swapped in and out by a type of market maker, rather than being bought and sold for cash by the fund itself. Since these "in-kind" transactions are not taxable events, appreciated securities can be swapped away without triggering a tax bill.



❶ An investor owns several stocks in their SMA. One of the stocks, Nvidia, has grown to be outsized in the portfolio.

❷ Rather than simply sell some Nvidia and face a capital gains tax bill, the investor converts the portfolio into an ETF.

❸ Once the ETF starts trading, the fund manager arranges flows in and out. These are used to remove some Nvidia and add a new position, in this case shares of an S&P 500 fund.

❹ Moving shares in and out of an ETF doesn't create a taxable event. The portfolio has been rebalanced without a capital gains tax bill.

Source: Bloomberg reporting

To facilitate these swaps, sometimes a fund manager will arrange for artificial flows in and out of the ETF. That creates a pattern known as a heartbeat — which was exactly what TSPX displayed in its first few days of trading.

Hard to Spot

While ETFs have plenty of other advantages such as liquidity and transparency, there's little doubt their tax perks are a big part of why the US industry has ballooned to more than $11.5 trillion in assets. The benefits mean ETFs can often outperform equivalent mutual funds after-tax, fueling Wall Street's mass migration toward the newer structure.

Last year a record number of mutual funds converted into ETFs. At the same time, at least 50 managers from BlackRock Inc. to State Street Corp. have applied to attach an ETF share class to their mutual funds — a structure perfected by Vanguard and previously protected by patent — that will effectively graft the tax advantage onto their existing products.

Unlike those adaptations, 351 conversions are hard to spot. They are used mostly for the holdings of hedge funds and SMAs, whose portfolios are often not publicly known. The clearest clue is when an ETF boasts a large amount of assets from the get-go: the biggest so far was Eagle Capital's $1.8 billion launch in 2024, which combined several hundred clients' SMAs.

351 Conversions Are Growing

These transactions, which aren't labeled in any way, can be hard to spot

ETF name	Ticker	Launch date	Assets at launch
Castellan Targeted Equity ETF	CTEF	6/18/25	$313m
Cambria Endowment Style ETF	ENDW	4/10/25	95
Longview Advantage ETF	EBI	2/27/25	434
Twin Oak Active Opportunities ETF	TSPX	2/21/25	440
Rockefeller US Small-Mid Cap ETF	RSMC	10/11/24	751
Eagle Capital Select Equity ETF	EAGL	3/21/24	1,782
CCM Global Equity ETF	CCMG	1/17/24	767
The Brinsmere Fund - Conservative ETF	TBFC	1/12/24	270
Bushido Capital US Equity ETF	SMRI	9/14/23	226
Kovitz Core Equity ETF	EQTY	12/12/22	652

Source: Data from Bloomberg; examples identified from reporting, filings, previous articles

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Often the issuer of the fund will be a firm catering to taxable investors. And some 351s rebalance their portfolios using heartbeat trades soon after launch. For example, the $370 million Castellan Targeted Equity ETF sold its largest holding — a roughly $20 million bet on Palantir Technologies Inc. — within three days of its listing last month. (Castellan Group says it evaluates the fund's positions daily and makes adjustments "as needed" to align with its prospectus objectives.)

Many 351 conversions occur under the same money manager and continue with their existing strategy, yet broad demand means some now take contributions from a slew of investors. In these instances, an ETF can begin trading with a hodgepodge of securities that need to be realigned with the fund’s objective.

For example, the Stance Sustainable Beta ETF, which tracks a fossil fuel-free index, was seeded with large positions including Exxon Mobil Corp. and Chevron Corp., which it offloaded within three trading days using heartbeat trades. (Kyle Balkissoon, who co-manages the fund, says “there are no hard and fast rules” to rebalancing and changes are made in consultation with the firm's legal counsel.)

There are some signs even larger ETF issuers are pursuing 351 conversions. Avantis Investors, an American Century Investments unit that runs about $75 billion, in March debuted the Avantis US Quality ETF that showed the hallmarks of a conversion. It began with about $120 million in assets, including a small amount of other ETFs and foreign securities that were sold within roughly a month. A recent Avantis filing says some funds may be seeded through in-kind contributions of securities with low tax basis. The firm didn’t respond to requests for comment.

Conversion could be a “perfect solution” for investors with concentrated stocks, direct-indexing portfolios with no losses left to harvest, or simply a need for strategic rebalancing, according to Meb Faber, co-founder of Cambria Investment Management. It has launched two conversions so far, the Cambria Tax Aware ETF and Cambria Endowment Style ETF, which listed with around $26 million and $95 million in assets, respectively.

“We expect funds three and four to be sequentially bigger,” Faber says. Next year “will be the year 351 goes mainstream,” he says.

‘Unjustifiable’

To critics, the growth of these conversions is a sign that ETFs’ tax advantages — while perfectly legal — are now being exploited at a scale that’s increasingly incompatible with a system meant to tax investments when they are sold.

“At the end of the day, we really will have been able to diversify our portfolios from high-tech stock to foreign stock, for example, from stocks to bonds without tax — and to me that’s a big issue,” says Jeffrey Colon, a law professor at Fordham University who’s been a longtime critic of ETFs’ tax benefits. “We shouldn’t have these vehicles out there that are just black holes for capital gains.”

In an effort to stop investors from using 351 conversions to diversify tax-free, a diversification test was later added. To qualify, a single position cannot be more than a quarter of the portfolio being converted, and five or fewer positions cannot exceed more than half. For the purposes of this so-called 25/50 rule, an ETF is evaluated in terms of its underlying holdings, which might explain why many conversions hold other ETFs.

In the view of Elwood at Practus, issuers should only seed ETFs with securities aligned with the fund strategy and wait “a reasonable amount of time” before selling some of those initial positions. Better yet, managers should document an investment case for their trades.

“The whole idea with tax ownership is you have to be exposed to the economic benefits and burdens of owning something,” he says. “So if, for example, you had something in your portfolio and you got rid of it a day later, it’s just a very transitory economic exposure.”

The current wave of conversions is a sign the 25/50 test is inadequate given an investor can fulfill it while still greatly diversifying their portfolio, according to Steven Hodaszy, a professor at Robert Morris University who has studied ETF taxation.

“The substantive result that we’re allowing affluent investors to rebalance their portfolios without recognizing gain on their appreciated securities is unjustifiable from a policy perspective,” Hodaszy says.

Deferral of a capital gains tax bill can be a significant benefit, since an investor can wait to sell until they’ve retired and are in a lower tax bracket — or reset the basis entirely when they die and pass the assets to their heirs.

Nonetheless, undertaking a 351 is no free ride, according to Brittany Christensen, head of business development at Tidal Financial Group, a white-label firm that helps launch ETFs. She points out a conversion can be an effective way to defer taxable gains, but says potential issuers have to weigh the benefits against the transparency and regulatory compliance that come with running an ETF.

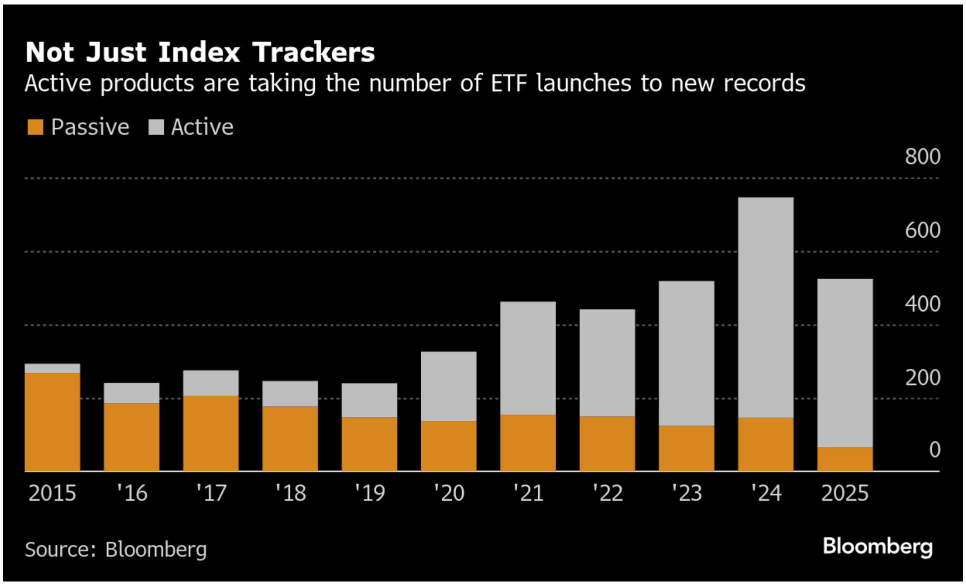
“Even though you might make up the majority shareholder, you still have to manage the fund from a fiduciary perspective as though anybody could be the shareholder,” Christensen says. “And that doesn't always feel like the same experience for a family office who's typically never had to make investment decisions in that same vein.”

Top Priority

Tax minimization was ranked alongside wealth preservation as the number one priority among advisers serving high-net worth individuals, according to a survey by Cerulli Associates last year. Conversions are just one part of a booming Wall Street business helping do that. There are also ETFs in the pipeline that will trade in and out of assets with the goal of avoiding taxable distributions, long-short strategies built to generate offsetting losses, and even hedge funds trying to cut income taxes.

In the two decades through 2023, ETFs realized capital gains worth on average 4.1% of its assets every year, but distributed just 0.12% in taxes, according to an academic paper. Meanwhile, passive and active mutual funds distributed 2.1% and 3.7% respectively. Extrapolating from that, the authors estimated between $1.4 trillion to $2.5 trillion in capital-gains tax would be deferred over the next decade on the existing stock of US equity ETFs.

“Everybody expects to use ETFs for the ‘benefit’ of taxable investors, so it’s part of why ETFs are appealing,” says Rabih Moussawi, a finance professor at Villanova University and one of the co-authors of the research. “Who’s going to fund all this deficit that we are seeing and all the debt that we are having if we don’t collect these legitimate sources of revenues? These questions have to be dealt with.”



The owners of TSPX so far cannot be identified based on regulatory filings submitted by institutional investors. Within a week of launching, the fund realized $97.8 million of gains, a filing showed. Since the initial flurry of activity, there's been little trading and the product has retained only its S&P 500 stake and two of the original fixed-income ETFs.

Garrett Stevens is CEO of Exchange Traded Concepts, a white-label firm that worked on TSPX. Speaking generally about the industry, he says the tax advantages of ETFs — including 351s — have been luring family offices who prefer to keep a low profile.

"They're really not that interested in marketing it typically," Stevens says of their 351s. "If additional flows come in, fine, but the intent is not to go out and raise assets."

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