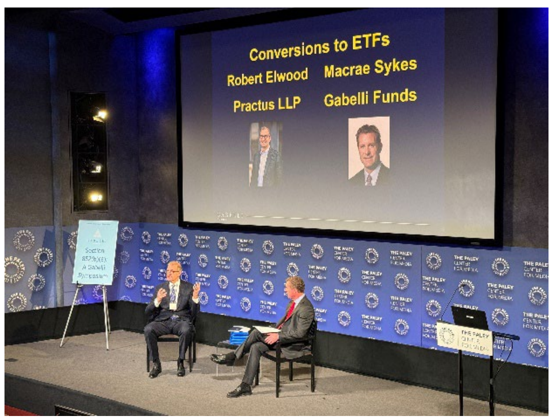
Gabelli Funds
191 Mason Street
Greenwich, CT 06830
Tel (914) 921-5000
www.gabelli.com

December 9, 2024

GABELLI
FUNDS

Taxes. . . Mutual Funds/ETFs. . . Fairness
Gabelli Conference
Section 852(b)(6)
Dynamics and Implications
for the Funds Industry 2.0

December 5, 2024
The Paley Center
New York City



Panel #1 - Conversions to ETFs - Mutual Funds and SMAs
Robert Elwood, Partner & Co-Founder, Practus LLP

Panel #2 - ETF Tax Alpha, Capital Migration, and Clienteles
Rabih Moussawi, Professor, Villanova University

Panel #3 - Section 852(b)(6) - Innovation, "Heartbeats," and Taxes
Jeff Colon, Professor, Fordham University of Law
Elisabeth Kashner, Director of Funds Research & Analytics, FactSet
Zachery Mider, Reporter, Bloomberg News

Moderated by Macrae Sykes, Portfolio Manager, Gabelli Funds

Macrae Sykes
(914) 921-5398

-Please Refer To Important Disclosures On The Last Page Of This Report-

Gabelli Funds
190 Mason Street
Greenwich, CT 06830
Tel (914) 921-5000
www.gabelli.com

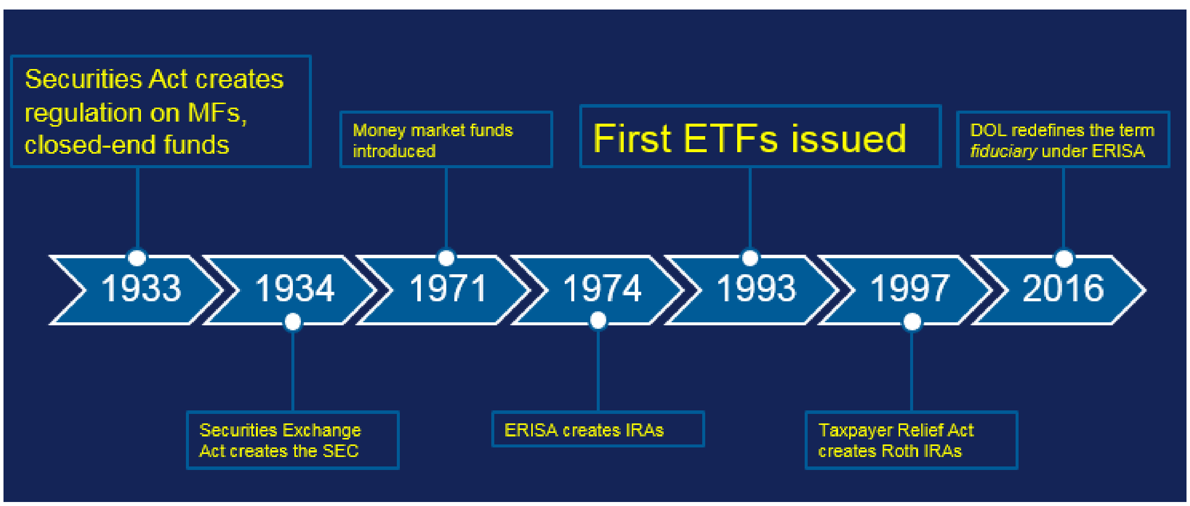
December 9, 2024

Taxes. . . Mutual Funds/ETFs. . . Fairness
Gabelli Conference
Section 852(b)(6) – Dynamics and Implications for the Funds Industry Conference 2.0
December 5, 2024
The Paley Center – New York City

On December 5th, the Gabelli Organization, as part of an ongoing effort to deliver industry education, hosted a unique line-up of industry and legal professionals to address several fundamental issues facing the funds industry today. The conference started by discussing recent trends around mutual funds (MFs) and separately managed accounts (SMAs) conversions to exchange traded funds (ETFs). Professor Moussawi from the second panel presented empirical evidence from his research that ETFs provide tax alpha relative to mutual funds and is a material component behind the industry demand for ETFs. The final panel addressed more comprehensively the issues of investment vehicle fairness in the market, with respect to the tax advantages of ETFs, while educating the audience about "heartbeat" trade dynamics. In short summary, the panelists provided a unique forum for understanding some of the dynamics unfolding and how industry participants and government regulatory authorities are reacting to the accelerating change.

BACKGROUND
In 1933, the first Securities Act was created leading to innovation of investment funds. Since then, the industry has seen many important changes including the creation of IRAs in 1974, ETFs in 1993 and changes to the fiduciary standard.

Exhibit 1 **Significant Events in Fund History**



Source: ICI.

At the end of 2023, the domestic mutual funds industry totaled over $33.9 trillion and is largely dominated by mutual funds.

Table 1 **Fund Industry AUM 2023**

Total *($, trillions)*	**$33.9**
Mutual Funds	**25.5**
ETFs (US)	**8.1**
Closed End Funds	**0.3**

Source: ICI.

Growth of ETFs
The growth of ETFs has been dramatic. In 2000, the total industry assets under management in the United States was $66 billion. At the end of 2023, that number had risen to $8.1 trillion. The strong growth has been helped by significant inflows and at the expense of traditional mutual funds. The first ETF, started in 1993, was State Street's SPDR S&P 500 Trust and now totals over $634 billion.

Table 2 **2023 Fund Flows**

	Active MFs	**ETFs**
Total *($, billions)*	**($664.7)**	**$597.2**
Equity	**(518.0)**	**402.3**
Fixed Income	**(108.5)**	**201.5**
Other	**(38.2)**	**(6.6)**

Source: ICI.

Section 852(b)(6)
Some of the growth attributed to ETFs is due to relative tax advantages over mutual funds. Because of structural differences, ETFs can take advantage of in-kind redemptions to distribute lower basis tax lots – essentially providing the ETF owner deferred tax treatment such that the investor only pays capital gains taxes when the ETF position is sold. It was previously estimated by Bloomberg that annual ETF unrealized distributed gains were over $200 billion.

The reason for the tax advantage is related to Section 852(b)(6), which provides for "exemption from gain recognition for in-kind distributions by mutual funds." The rule encompasses the whole mutual fund industry; however, in practicality, ETFs are the vehicles taking advantage of the deferred tax opportunity because of their structure. Mutual funds rarely do, given industry practice and the feasibility about redeeming diversified portfolios of securities for retail customers.

The ability to defer capital gains treatment is a major advantage for ETFs especially related to total return over time. In the below example, we provide an illustration of $10 million of invested capital at an 8% compounded annual return for 10 years. For the mutual fund investment, we assume a 20% annual capital gains tax is paid, while the ETF retains the capital and eventually pays a 20% tax on the accumulated earnings. (For simplicity, we assumed no dividend income or management fee impact). At the end of 10 years, the benefit to the ETF holder is approximately $700,000.

Table 3 **Mutual Fund vs. ETF Illustrative Return Example**

$10m at 8% annual return for 10 years

	Capital	**Taxes**
Mutual Fund	**$18,595,861**	**($2,148,965)**
ETF	**19,271,400**	**(2,317,850)**

$675,539

Source: Gabelli Funds.

TAKEAWAYS FROM THE CONFERENCE

Panel #1 – Conversions to ETFs – Mutual Funds and SMAs

Reasons for Conversions

Many advisors are looking at conversions for tax and non-tax reasons. As widely known, ETFs are more tax efficient than other vehicles. The non-tax reasons for converting include accessing liquidity and increasing visibility. Some people like how you can treat an ETF like a stock traded on an exchange.

Technical Steps for Conversion

The biggest hurdles to converting on the legal side include interacting with the SEC, but also the IRS and other tax authorities. The transitions are recognized as shell reorganizations. The challenge within securities law is with filings and shareholder votes. Another challenge is also that clients will need to hold the ETFs though a brokerage account, not just directly with the manager. At the major fund companies, there is a lot of infrastructure that can support the outreach needed for communicating with clients about converting a MF to an ETF. For smaller firms that do not have major call centers and scaled staffing, there are outsourced provider firms that can support the process.

The process of documentation has been mostly standardized, but you still need several forms including a plan of reorganization, potentially a N-14 to get shareholder approval and other tax documents. Since there is a history of conversions it is a straightforward process. In order to break even on an ETF, it needs to have assets under management of greater than $25 million. Many registered independent advisors (RIAs) have a base of $100 million+, but across many customers, and could create an ETF with a combination of RIA client contributions.

Practus LLP (the Panelist, Robert Elwood is a Practus LLP Partner) has done about 85 of the ~350 conversions to date. There has been a lot of interest, and the pace has accelerated.

SMA fees tend to be a little higher than ETF fees, so the advisor may have to consider the impacts of lower revenue from a conversion. It is important for the manager to spend a lot of time educating the clients about the benefits of conversion. In general, with the industry conversions, there has been relatively very little client/AUM attrition.

Conclusion

Tax mechanisms were originally intended to be an emergency stopgap for mutual fund liquidity and were not really used until ETFs emerged. ETFs with their unique structure can benefit disproportionately from Section 852(b)(6). ETFs also provide several other factors that may be more desirable to investors including lower cost, real time trading and little tracking error vs. traditional closed-end funds. The conversion pace is likely to continue with more activity occurring in 2025.

Panel #2 – ETF Tax Alpha, Capital Migration, and Clienteles

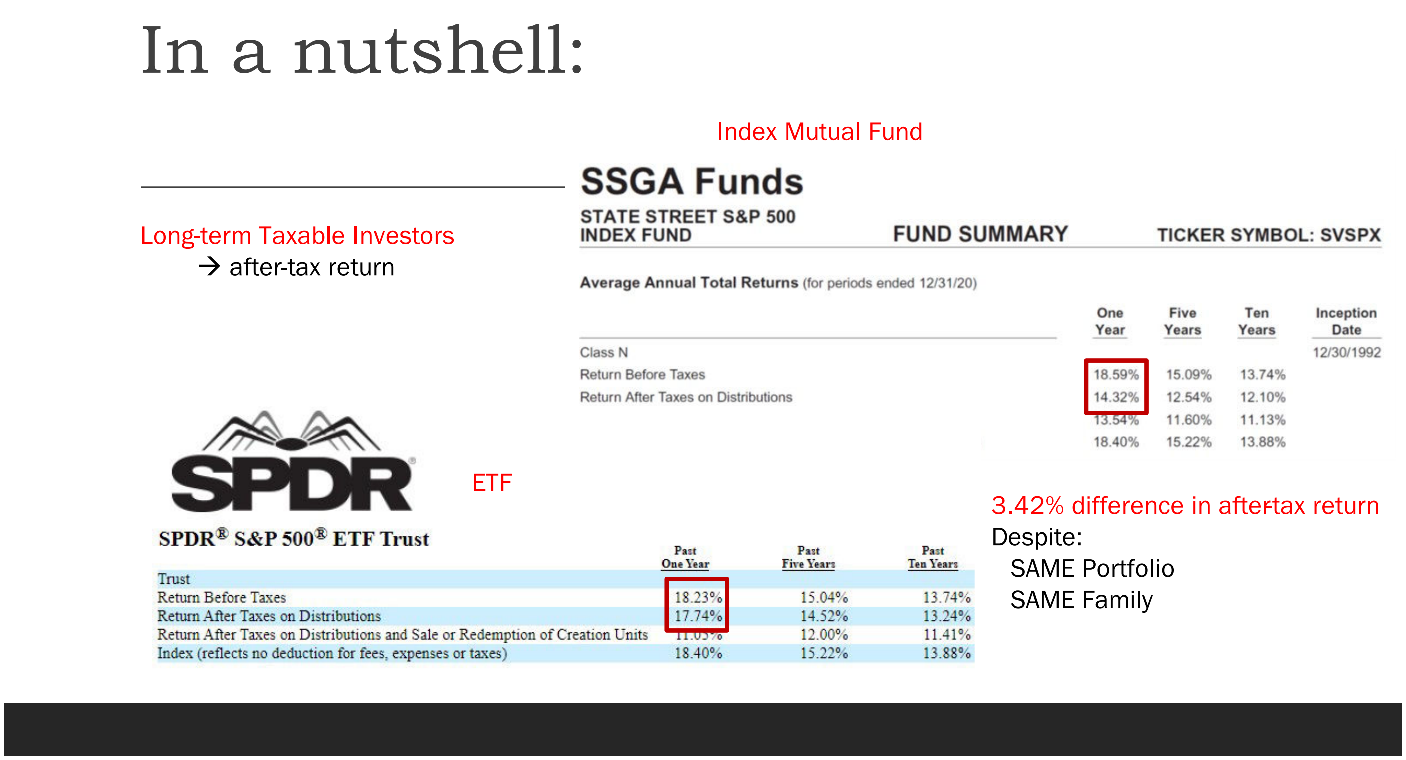
Conversions into ETFs are a next phase of growth

The conversions started in 2020 and have been accelerating since. It's important because most of these conversions happen due to superior tax treatment that can make a large difference over time.

ETFs benefit from Tax Alpha

Aggregate fund flows (Table 2) from MFs to ETFs reflect several competitive dynamics, but tax advantages are a big component of that. At a high level, the tax alpha can be observed between like index products offered by advisor, State Street Global Asset Management. The State Street S&P 500 Index Mutual Fund (SVSPX) had a gross return in 2020 of 18.59% and the post-tax return of 14.32%, whereas the same strategy in an ETF vehicle (SPDR S&P 500 Index ETF (SPY)) had a gross return of 18.23% and post-tax return of 17.74%. That ~3% difference is the "ETF Tax Alpha", which is significant, especially when compounded over longer periods of time.

Exhibit 2 **Measuring Tax Alpha**



Source: Professor Rabih Moussawi, Presentation, December 5, 2024.

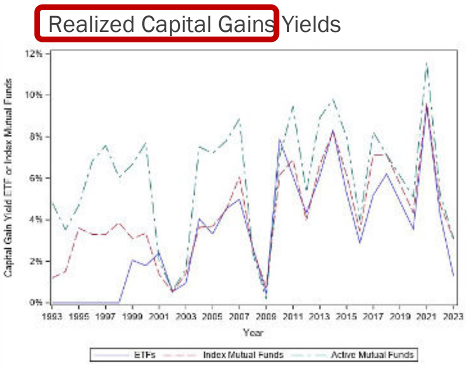
The above example is one simple, quantitative way of understanding the tax advantages. Professor Moussawi researched a more comprehensive sample of funds to highlight the tax deltas. Specifically, his sample included 1,710 equity ETFs, 618 Index Mutual Funds and 3,022 Active Mutual Funds.

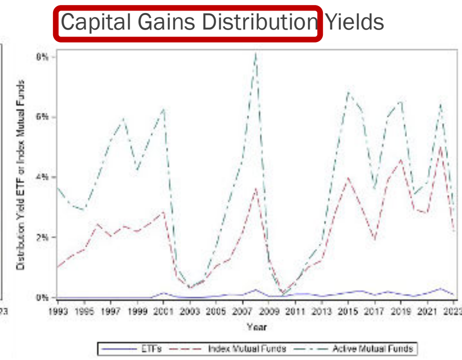
Because MFs are pass-through entities, they have annual dividends and capital gains distributions. These distributions are not trivial: sometimes reaching 30% of net asset value (NAV). Because of these distributions, taxable investors may pay taxes even if they did not sell their shares. This is what is called "negative externalities."

The in-kind redemption exemption was developed under Tax Reform Act of 1969 and later codified in 1986 as Section 852(b)(6) in the US Internal Revenue Code. ETFs, by design, rely heavily on in-kind redemption and creation with authorized participants (APs). Because MFs distribute in cash, they cannot take advantage of the in-kind redemption exemption. This enables deferral of most short-term and long-term realized gains until investors sell their ETF shares. This is very valuable for long-term taxable investors: "interest-free loan + conversion of short-term gains + step-up in basis."

Exhibit 3 **Examination of Capital Gains Among Sample Funds**

Capital Gains: realized vs. distributed





Year	Cap Gain Distribution Yield (%)		
	ETF	*IMF*	*AMF*
2013	0.06	1.24	1.83
2014	0.11	2.81	4.51
2015	0.18	3.98	6.82
2016	0.23	3.01	6.23
2017	0.10	1.92	3.59
2018	0.21	3.91	6.02
2019	0.12	4.58	6.57
2020	0.06	2.94	3.44
2021	0.15	2.81	3.84
2022	0.30	5.02	6.43
2023	0.11	2.22	2.92
Avg.	***0.15***	***3.13***	***4.75***

→ TaxDeferral on at least 3% of AUM in cap gains distributions!

Source: Professor Rabih Moussawi, Presentation, December 5, 2024.

Exhibit 4 **Examination of Net After-Tax Returns**

Realized vs. Distributed Capital Gains vs. Overall Tax Burden

- $TB_{f,t} = \tau_t^{DIV} Y_{f,t}^{DIV} + \tau_t^{SCG} Y_{f,t}^{SCG} + \tau_t^{LCG} Y_{f,t}^{LCG}$ → Net After-tax return ≈ Gross return – fees – Tax burden

Tax Efficiency

Fee Efficiency

Year	Dividend Yield (%)			ST Cap Gains Dist. Yield (%)			LT Cap Gains Dist. Yield (%)			Tax Burden (%)			Expense Ratio (%)		
	ETF	*IMF*	*AMF*	*ETF*	*IMF*	*AMF*	*ETF*	*IMF*	*AMF*	*ETF*	*IMF*	*AMF*	*ETF*	*IMF*	*AMF*
1993-2001	1.57	1.08	0.65	0.05	0.58	1.19	0.02	1.52	2.96	0.64	1.01	1.42	0.23	0.78	1.45
2002-2011	1.14	0.95	0.5	0.09	0.22	0.39	0.02	0.9	1.44	0.24	0.37	0.44	0.44	1.01	1.47
2012-2023	1.39	1.00	0.76	0.09	0.65	0.67	0.05	2.59	4.02	0.37	1.13	1.42	0.50	0.92	1.21
1993-2023	**1.36**	**1.00**	**0.64**	**0.08**	**0.48**	**0.72**	**0.03**	**1.68**	**2.8**	**0.41**	**0.83**	**1.07**	**0.40**	**0.91**	**1.37**

Source: Professor Rabih Moussawi, Presentation, December 5, 2024.

Tax Efficiency Advantages Impact on Mutual Fund Outflows

Client redemptions and outflows force early realization of capital gains for ETFs and MFs. But, only on MFs are capital gains distributed to remaining investors. Because of this, there are no negative externalities for other ETF investor flows: "your taxation depends on what you do, not what others do." The ETF in-kind redemption mechanism reverses the negative impact of outflows on capital gains distributions, lowers the tax overhang (unrealized gains) and reduces the tax burden. Based on the empirical data, tax efficiency is a more significant variable than fee efficiency in explaining the flow trends between MFs to ETFs.

Exhibit 5 **Tax Dynamics And Future Flows**

Determinants of Future MF Flows

NSAR/NPORT Total Redemptions

	Net Flows (%)	Outflows (%)
Standardized RHS variables	(1)	(2)
Annual Excess Return	0.053***	-0.012***
	(12.57)	(-6.30)
Fee Gap	-0.053***	0.006**
	(-10.45)	(2.47)
Tax Burden Gap	-0.026***	0.016***
	(-6.09)	(4.16)
Controls	Yes	
Fixed Effects	Style & Date	
Clustering	Fund & Date	
Observations	1,693,203	1,408,370
R-squared	0.041	0.127

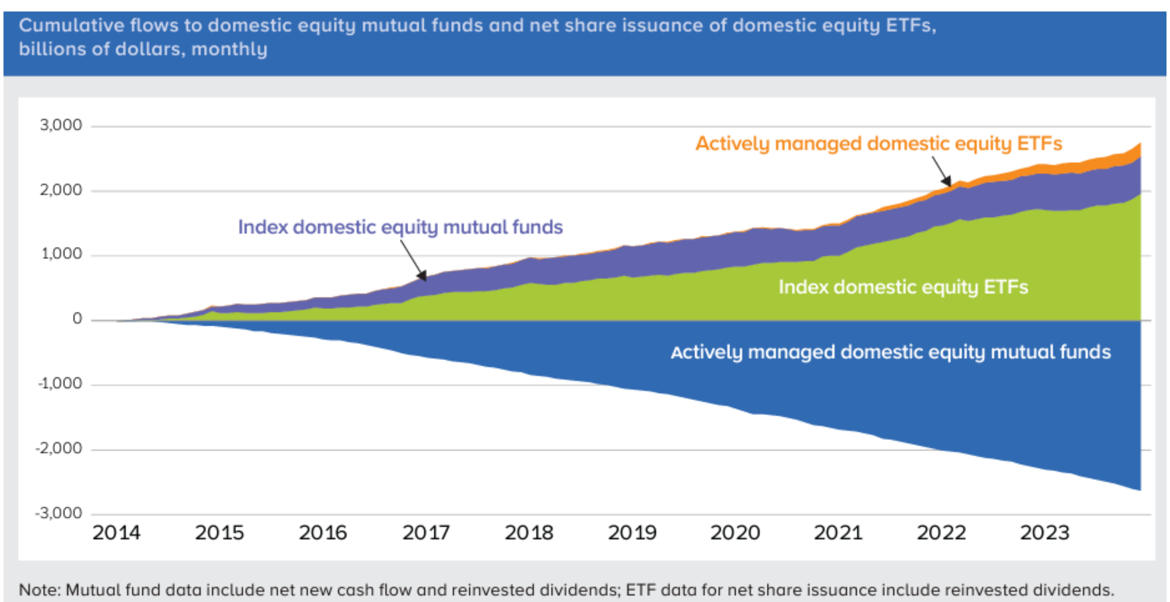
Horse Race

Controls: Style category Flows, log(Assets), log(Age), return volatility, retail dummy

- One std dev. increase in tax burden→ 1.6% more outflows >> effect of 1 std dev increase in fees
- Tax efficiency dominates fee efficiency in explaining outflows
- Investors are better off leaving the fund as soon as they observe indications of higher realized gains and before they are distributed→ last two months of the year
- Effect disappears for funds held in retirement and other tax-deferred accounts
- Conclusion: Tax-sensitive investors played a big role in mutual fund outflows

Source: Professor Rabih Moussawi, Presentation, December 5, 2024.

Exhibit 6 **Cumulative Industry Flow Trends**

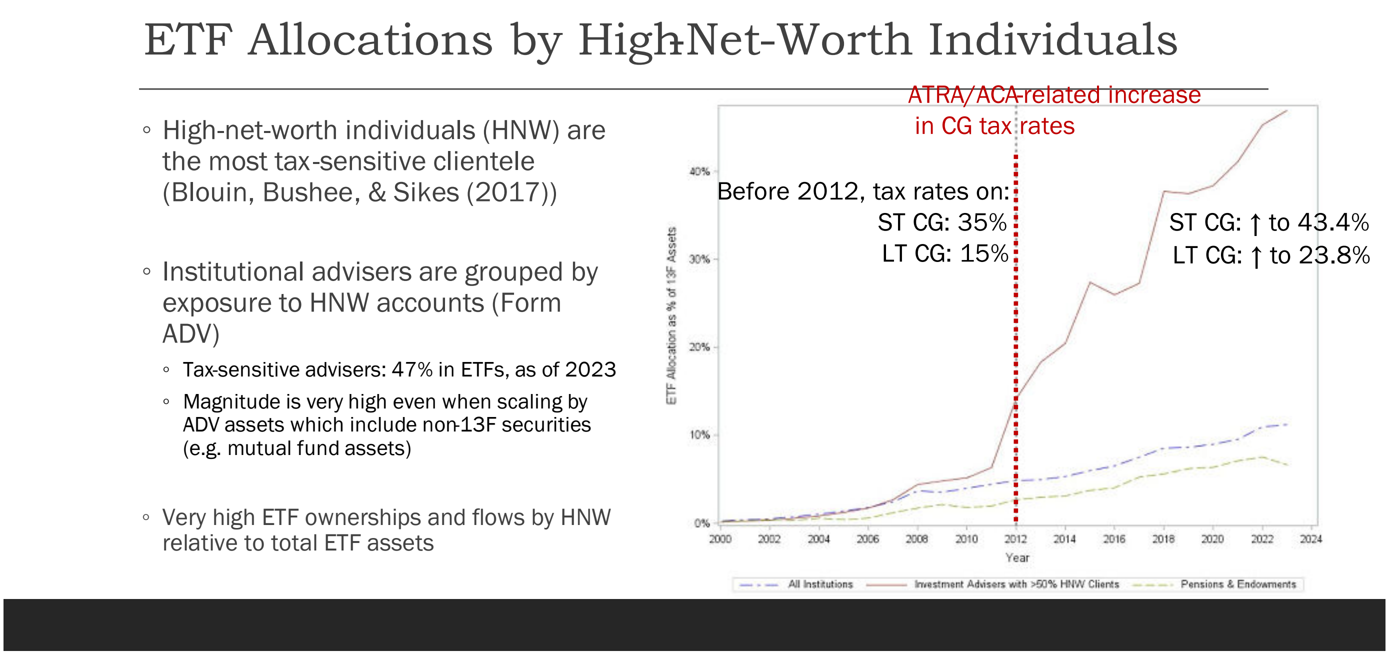


Source: ICI.

Taxable vs. non-taxable Clienteles
As of the end of 2023, ICI estimated that the number of households owning mutual funds totaled 68.7 million or approximately 52.3% of all households. In 2000, the number of households owning mutual funds in tax-deferred accounts was 27 million. By 2023, that number had risen to 45.9 million or approximately 67%. In contrast, the number of households holding just taxable accounts in mutual funds has declined over that time.

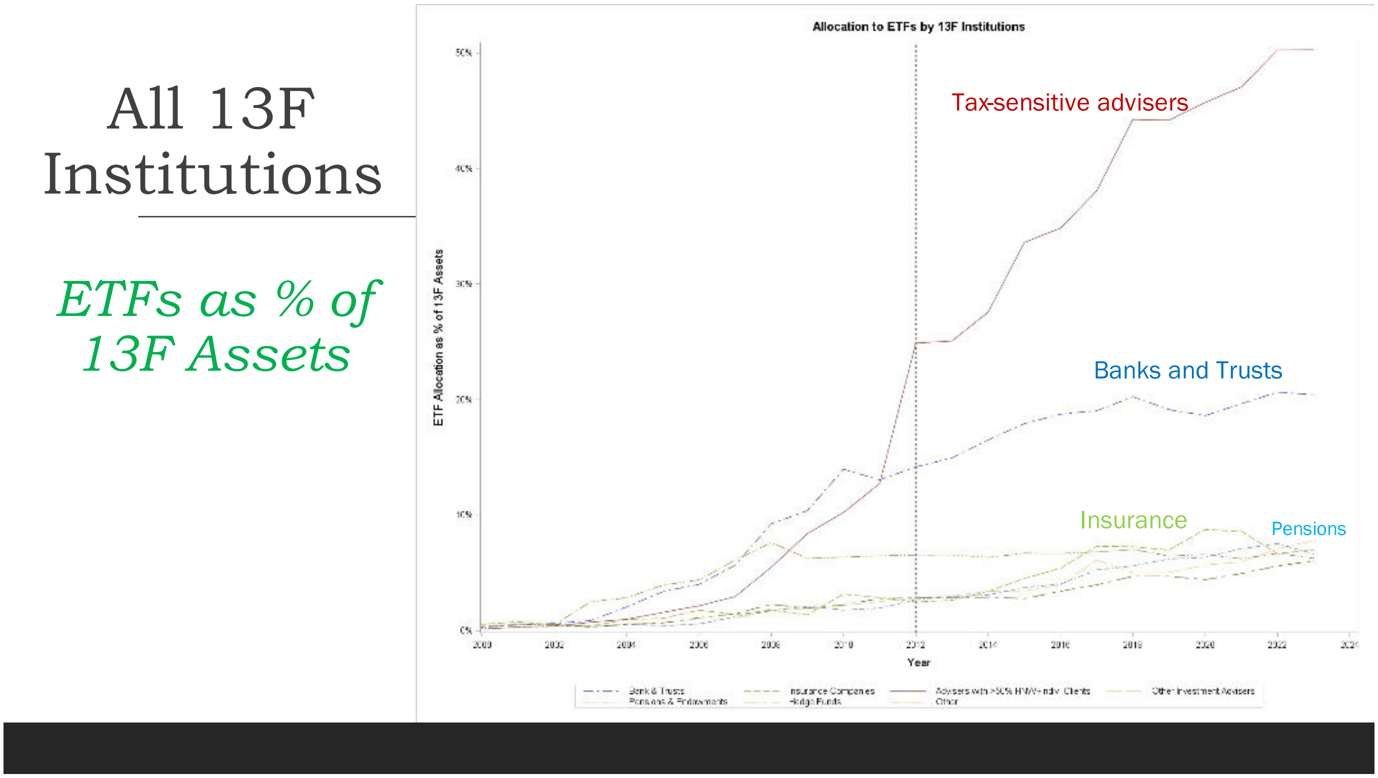
The ICI data and Professor Moussawi's findings suggest that most of the movement from MFs to ETFs has been from tax sensitive clienteles. According to a paper by Blouin, Bushee & Sikes (2017), high-net-worth individuals (HNW) are the most tax sensitive. Additionally, one major catalyst for increased tax sensitivity for this segment was the tax code change in 2012, where short-term and long-term capital gains rates were increased from 35% and 15% to 43.8% and 23.8%, respectively.

Exhibit 7 **Tax Sensitive Clienteles**



Source: Professor Rabih Moussawi, Presentation, December 5, 2024.

Exhibit 8 **Tax Sensitive Clienteles**



Source: Professor Rabih Moussawi, Presentation, December 5, 2024.

Conclusion

"A tax deferred is an interest-free loan from the US Treasury Department." (Source: Jack Bogle 1997). After careful examination of the funds industry, Professor Moussawi concludes that the significant vehicle migration from MFs to ETFs, includes a host of variables, but is largely explained by the tax advantages of ETFs and rational behavioral shifts by taxable investors. The long-term findings show an average reduction in tax burden of 1.05% in recent years and a significant reduction in tax overhang. HNW investors and investment advisors with HNW client concentrations are taking advantage of ETFs due to little to no annual capital gains distributions and an eventual step-up in basis of ETF securities to heirs.

#3 Panel – Section 852(b)(6) – Innovation, "Heartbeats," and Taxes

Heartbeat Trades

The heartbeat trade is an extension of the ETF creation and redemption process and how in-kind redemptions are not taxable events. If you are an asset manager, no one wants to see redemptions because it is a reduction in fee revenue. In the ETF space, there's a silver lining to redemptions.

A heartbeat is an adaptation to a lack of redemption activity. ETFs with tremendous turnover like the sector SPDRs, for example, have inflows and outflows many times a week. For the sleepier ETFs, they might not have redemptions very often. The way it works is that a couple of days prior to when the redemption needs to happen, an AP will make effectively a short-term loan to the advisor by making a creation, but the dollars that go in will be, to a close approximation, what needs to come out. It works very similarly to a normal creation; however, the dollars are not driven by typical capital markets activity, but through the AP. The redemption is generally split in that anything that the advisor can sell at a loss will be executed in the capital markets. The loss will accrue to the fund. Anything that will be a gain will be put in the redemption basket, and, interestingly, if you go look at the trading tape and try to find the redeemed transactions, you will not see them because they do not hit the tape. Essentially, a heartbeat is a way to make a redemption appear at the exact time and at the exact size the advisor would like.

It is relatively easy to find the percentage of ETFs making capital gains distributions in any given year. In the previous era, anywhere between 5-8% of ETFs made a capital gains distribution. That number has fallen precipitously to under 4%, except for 2021, with a rise of around 9% due to some unique idiosyncratic impacts. Essentially, it appears that firms are using more heartbeat trades to improve tax efficiency.

New Entrants that are looking to Maximize Tax Treatment
The ability to defer capital gains and taxes is a very powerful tool, and it is something that the markets are only just now starting to utilize. An example is the BOX ETF. This advisor learned how to create a treasury bond-like return without having any taxable distributions to the investors. They did it through using options and derivatives to generate a very similar product to treasury bills without incurring taxable events. Essentially, improving tax efficiency on capital gains and on investor income.

Potential Regulatory Changes – How and by what government agencies?
852(b)(6) is in the statute. Some of the things talked about during the panel are not in the statue, but in the regulations. The IRS could change this, but probably wouldn't. The first thing that we would have to do is estimate what the cost of 852(b)(6). Each year, in the tax expenditure there is a line item, but there is no estimate associated with it. What's interesting is that the Wall Street Journal estimated a few years ago the number to be about $200 billion. Now, with the MF-ETF conversions, with the BOX ETF, whatever number it was in 2020, it must be a multiple of that now. This really benefits very wealthy taxpayers, the top 3-5% of earners. The question is: "who does this tax benefit really go to?" The IRS knows about heartbeat trades. If the IRS was going to come after some investors/advisors, it would have done so already.

Other Areas of ETF Innovation
There are some large private wealth family offices that are focusing on strategies like the BOX ETF. There is also really no limit to how many times you can do use the ETF structure to increase tax efficiency. You can keep seeding ETFs with old ETFs. "It's not that hard."

Change in Executive Branch and Upcoming Budget Debates – Catalyst for Seeking Sources of Revenue
It is a challenge to push through any tax reform. The industry is rock-solid behind preserving the benefit of Section 852(b)(6). There have not been any Republicans pushing for reform, so they are unlikely to challenge this. There is a possible scenario though for change. When the 2017 tax package come through, it was not just a series of cuts, it was some tax benefits that got taken away in "blue states." There was also a tilt towards certain industries and away from "knowledge" workers like consultants. There could be some Republican interest if there's sufficient analysis showing the distribution of the beneficiaries.

Advisor Control Changes with an SMA Conversion to ETF
Everything has a tradeoff. An ETF must be listed on the capital markets. Even if that is touted as an advantage; it's costly. It's not free. Also, there is some tradeoff of control for diversification. Maybe it's ok if it's not free, but it's a decision that every investor must make.

2028+ Landscape – Expected Changes
"Probably won't go broke by betting on inaction in tax reform, generally." Some hope that there is further discussion about how to tax ETFs. It would be a goal, but don't expect it to happen.

The ability for Republicans to raise taxes in any form is unlikely. The 2026 midterm elections are unknown. The issue is when you start to think about how you would write these policies. They are very technical. Regulating heartbeats is very appealing and has a very simple fairness story. Those who study heartbeats must resort to crude statistical methods.

Additionally, it may not be possible technically to build the infrastructure to detect those trades. That would require additional work and creativity. The fairness story might be worth it. Super easy to say, "some shareholder wants to redeem to buy a vacation home and every buy and hold investor has to foot their tax bill." The American public would scoff and say it isn't fair. The fairness story is there, but the execution, on a technical level, is extraordinarily difficult.

You can view a replay of each panel on our Youtube channel:

Macrae Sykes
(914) 921-5398
msykes@gabelli.com

ONE CORPORATE CENTER RYE, NY 10580 Gabelli Funds TEL (914) 921-5000 Fax 914-921-5098