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The ETF Tax Dodge Is Wall Street's "Dirty Little Secret"

Banks are pumping billions of dollars into and out of funds with "heartbeat" trades.

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One day last September an unidentified trader pumped more than $3 billion into a tech fund run by State Street Corp. Two days later that trader pulled out a similar amount.

Why would someone make such a large bet—five times bigger than any previous transaction in the fund—and then reverse it so quickly? It turns out that transfusions like these are tax dodges, carried out by the world's largest asset managers with help from investment banks. The beneficiaries are the long-term investors in exchange-traded funds. Such trades, nicknamed "heartbeats," are rampant across the $4 trillion U.S. ETF market, with more than 500 made in the past year. One ETF manager calls them the industry's "dirty little secret."

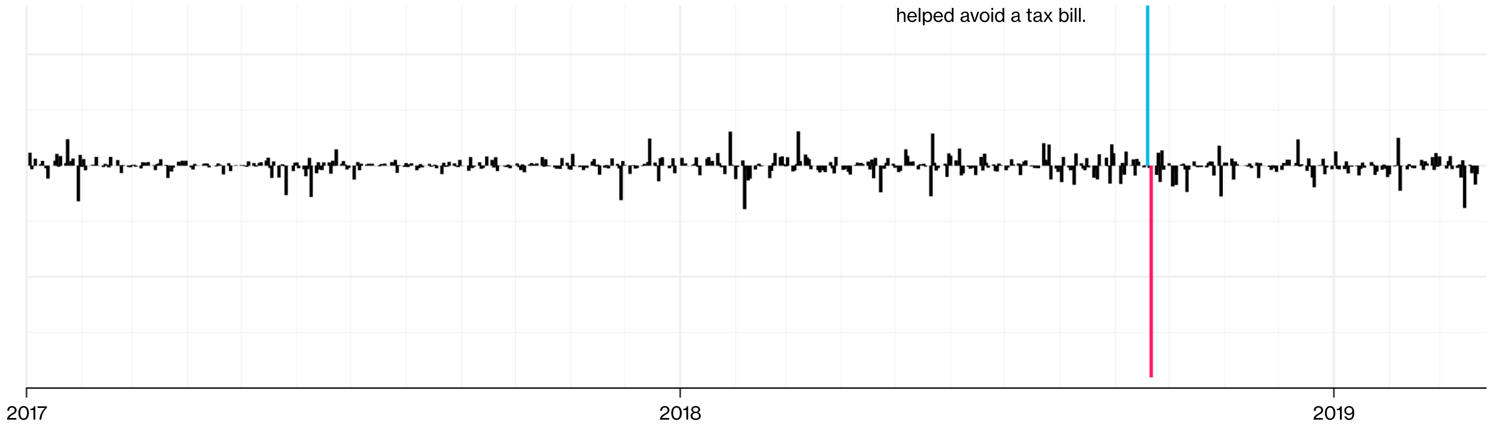
Typically, when you sell a stock for more than you paid, you owe tax on the gain. But thanks to a quirk in a Nixon-era tax law, funds can avoid that tax if they use the stock to pay off a withdrawing fund investor. Heartbeats come into play when there isn't an exiting investor handy. A fund manager asks a friendly bank to create extra withdrawals by rapidly pumping assets in and out.

That's Quite a Pulse

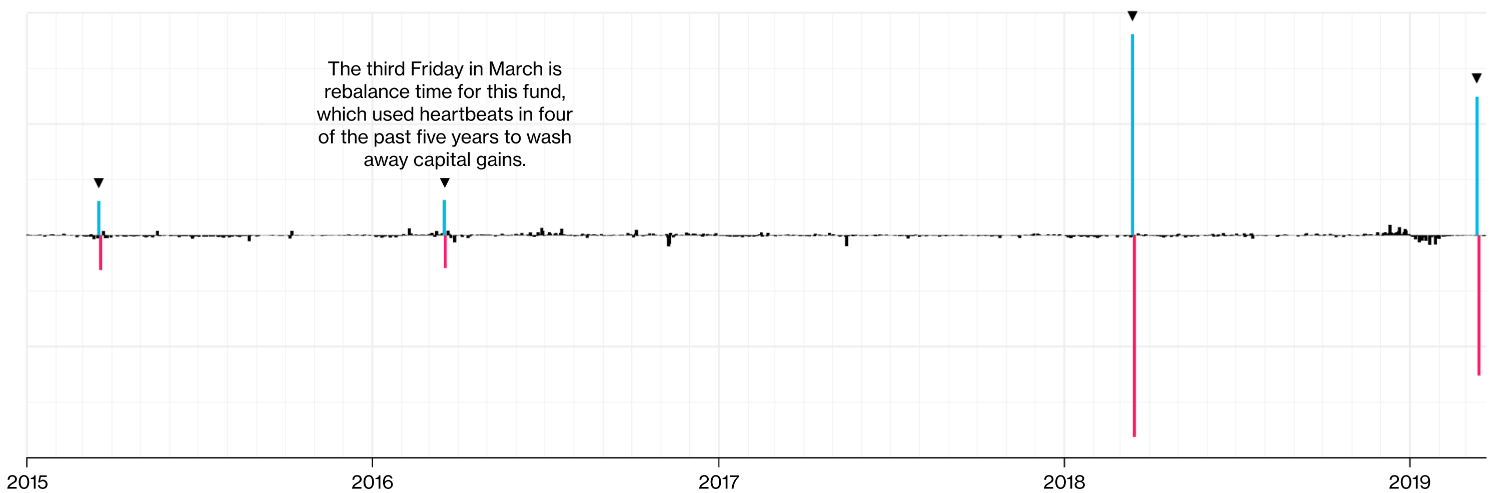
Banks help ETFs avoid billions of dollars in taxable gains by quickly pumping money in and out

State Street's Technology Select Sector SPDR

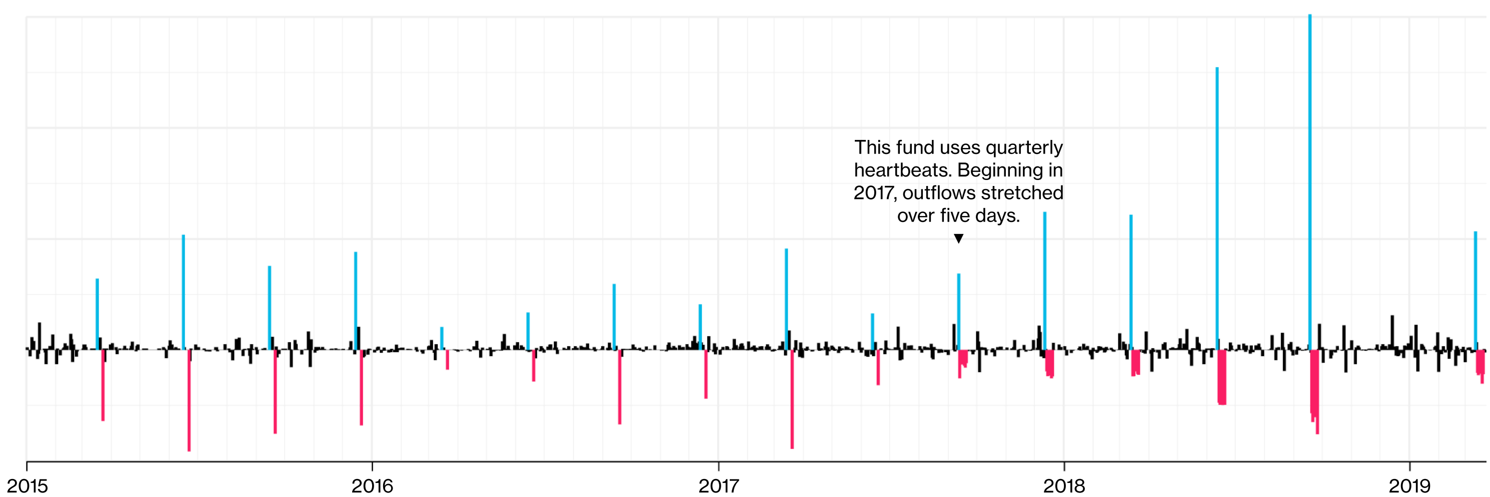
Inflow Outflow Fu



BlackRock's iShares Select Dividend ETF



Vanguard Small-Cap ETF



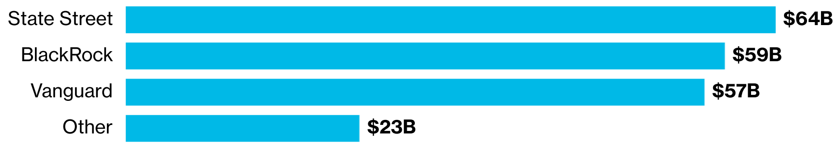
"If the IRS were looking at it, they would say that's a sham transaction," says Peter Kraus, a former chief executive officer of mutual fund manager AllianceBernstein Holding LP who now runs Aperture Investors LLC.

Imagine that a grocer got a tax deduction every time someone returned a box of cornflakes to his store. Heartbeats are when the grocer asks a friend to buy all the boxes and return them, just to pocket more deductions.

Fund managers and bankers say the trades are perfectly legal, and that most of the taxes that they help regular ETF investors avoid will be paid in later years. The biggest ETF managers, including BlackRock, State Street, and Vanguard Group, all use heartbeats, with help from banks such as Bank of America, Credit Suisse Group, and Goldman Sachs Group, according to market participants who spoke on condition of anonymity. Spokesmen for those companies either declined to comment on the trades or defended their use. The Internal Revenue Service says it's aware of heartbeats and wouldn't say whether it considers them an abuse.

The Fund Managers Reaping the Biggest Breaks

Tax-free gains booked by largest ETFs



Source: Realized capital gains from in-kind redemptions, compiled by Bloomberg from the most recent annual reports of the 183 largest equity ETFs

To people in the industry, heartbeats are just smart tax strategy. "It's removing a negative from the investment process," says Bruce Bond, a pioneering ETF executive who was among the first regular users of heartbeat trades. "There really isn't a need to have to pay the tax every year. The goal is the best investor experience you can have."

To understand heartbeats, it helps to know that they're just a supersize version of something ETFs do every day. ETFs are funds whose shares trade all day on stock exchanges. Unlike mutual funds, ETFs aren't sold directly to regular investors. Instead, they use banks and brokerage firms as middlemen. These large traders don't transact in cash. They make an ETF bigger or smaller by adding portfolio stocks to it, or by taking them out. They call this activity "creating" and "redeeming" ETF shares. (All this is invisible to small investors, who just buy ETFs from brokers.)

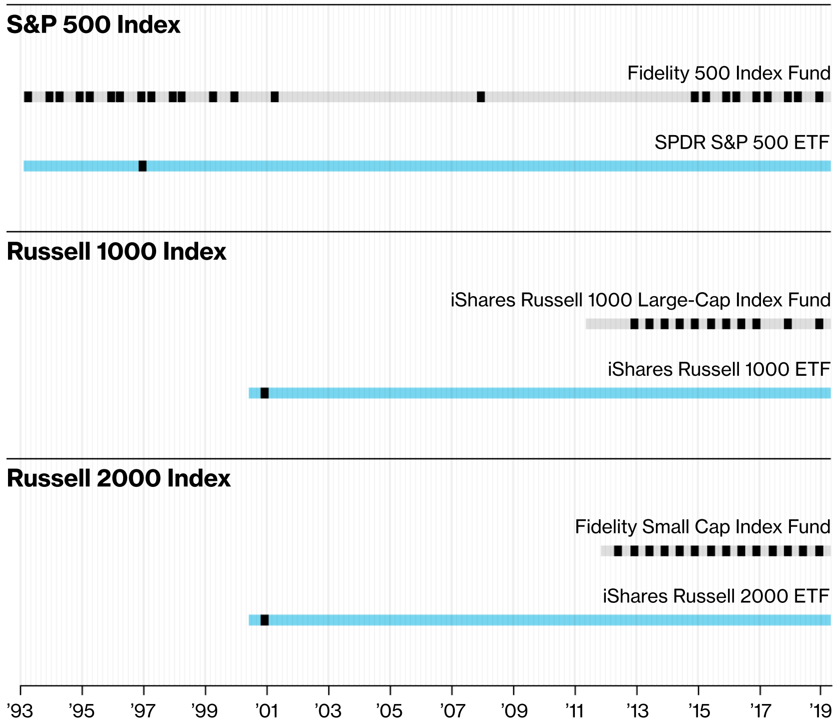
Enter the Nixon-era tax law. In 1969, Congress decreed that mutual funds can hand over appreciated stocks to withdrawing investors without triggering a tax bill. Lawmakers never explained why they blessed the industry with this unique break, but back then, it didn't seem like much of a giveaway. Mutual funds rarely took advantage of it, because their investors preferred cash payouts.

Fast forward to 1993, when American Stock Exchange executives devising the first U.S. exchange-traded fund realized they could put that old tax rule to a new use. Say an ETF needs to get rid of a stock that went up. Selling it would trigger a taxable gain that would ultimately be paid by fund investors. But handing the stock off to a broker who's making a withdrawal achieves the same goal, tax-free. Every time a broker redeems a stake in a fund, it's another chance to avoid taxes. That loophole gives ETFs a tax advantage over mutual funds. It went from a footnote in the tax code to the cornerstone of a new industry.

For some of the earliest ETFs, which followed broad indexes such as the S&P 500 and rarely changed holdings, the daily process of brokers creating and redeeming was enough to wash away almost all capital gains. The first and largest ETF, State Street's SPDR S&P 500 ETF, hasn't reported a taxable gain in 22 years. In contrast, a traditional mutual fund run by Fidelity Investments that tracks the same index had a taxable gain in 10 of those years.

Making Taxes Disappear

Compared with mutual funds that follow the same index, ETFs rarely saddle investors with ■ taxable gains



ETFs proliferated, and some new entrants shuffled their holdings more frequently, so routine redemptions weren't always enough to wipe out the taxes. The PowerShares funds, co-founded by Bond, started trading in 2003 and changed their portfolios every three months. He says his funds wouldn't have kept capital-gains taxes away without heartbeats. "This tool was there," says Bond, who sold PowerShares to Invesco Ltd. and now runs Innovator Capital Management LLC in Wheaton, Ill. "We were the ones to first really utilize it to its full potential."

U.S. stock ETFs avoided tax on more than $211 billion in gains last year, according to a Bloomberg Businessweek tally based on annual reports of more than 400 funds. The disclosures don't show how much of that is from the funds' routine use of the ETF loophole and how much is from special heartbeat trades that maximize the benefit. But heartbeats certainly contribute billions to the total.

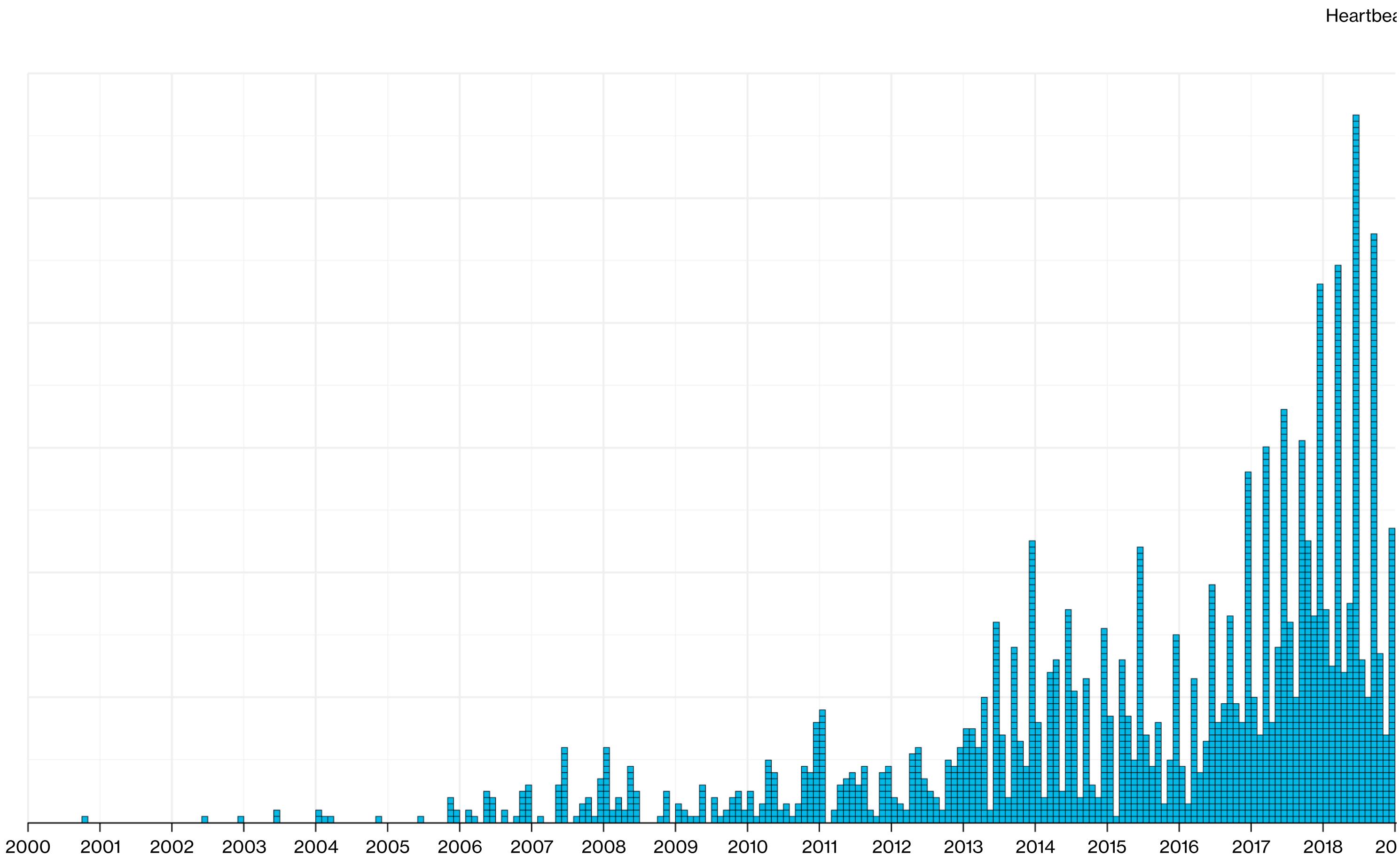
Funds pass taxable gains along to their investors, so by avoiding those gains, they're allowing investors to defer the tax until they sell the ETF itself. The $211 billion in avoided fund gains probably translates to about $23 billion in deferred taxes last year. It's the equivalent of a $23 billion, no-interest loan from the U.S. Treasury to ETF investors, with most of the benefit going to the wealthiest Americans.

Heartbeats have had a few nicknames over the years, including "friendlies," but they haven't attracted much attention outside the industry. Elisabeth Kashner, an ETF specialist at FactSet Research Systems Inc., was the first to write about the practice in a December 2017 report. She called them heartbeats because the telltale blips in fund-flow data on her computer screen reminded her of a cardiac monitor. Bloomberg Businessweek identified 2,261 such blips in equity ETFs since 2000. Last year there were 548, worth a record $98 billion.

Heartbeat Trades

Since 2000, there have been 2,261 heartbeat trades worth $330 billion

Heartbeat tally | Heartbeat value



Most heartbeats take place when an ETF has to get rid of stock because of a change in the index it tracks. That was the case in September with State Street's $23 billion Technology Select Sector SPDR. Some of the fund's largest holdings, including Facebook Inc. and Google parent Alphabet Inc., were being dropped from the portfolio because they were leaving the index the fund is designed to mimic. Both stocks had more than doubled since the fund first acquired them, so it probably faced a hefty tax bill if it sold them.

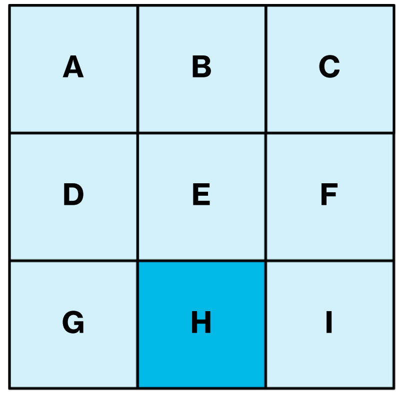
On Wednesday, Sept. 19, two days before the index change, $3.3 billion of new assets poured in, increasing the fund's size by 14 percent. The additions came in the form of stock that matched the fund's holdings at the time. The investor's identity wasn't disclosed, but market participants say that, given the size of the transaction, it was probably a large investment bank.

On Friday of that week, someone pulled more than $3 billion back out. Trading data suggest it was the same investor that had appeared two days before. Rather than take back the same shares of stock it had contributed 48 hours earlier, the investor appears to have walked away with the fund's oldest shares of Facebook and Alphabet, the ones with the biggest capital gains. Thanks to winnings on stocks like that, the fund reported more than $4 billion in capital gains for the year. But since it used the ETF tax loophole to shield those gains from taxes, its annual report shows, it ended up reporting a $309 million capital loss to the IRS.

How Heartbeat Trades Work

By asking a bank to quickly invest and then withdraw, ETFs can get rid of appreciated stocks without triggering taxable gains

An ETF owns a portfolio of stocks and needs to drop one of them, **Stock H**.



While State Street declined to comment about specific transactions, Olivia Offner, a spokeswoman for the company, says the "primary motivation" for such trades is not to cut taxes but to avoid pushing stock prices lower by selling large blocks all at once. Trading data show the State Street fund rarely, if ever, did a heartbeat before the September trade. Other funds do them like clockwork. BlackRock's iShares Select Dividend ETF has done one on the third Friday in March in four of the past five years. The Vanguard Small-Cap ETF has completed one at the end of almost every quarter since 2005.

Goldman Sachs took part in some of the first heartbeats in the early 2000s, according to people with knowledge of the bank's activities. Today it's a standard service for any bank with an ETF desk, and ETF market-making firms do them as well. A few days before an index change, fund managers simply call up a banker or market maker and ask them to pour a certain amount into the fund.

Bankers prefer to tie up their capital for as short a time as possible. But ETF managers worry that too brief a holding period would cause the IRS to deem the transaction a sham. Years ago, some banks were completing heartbeats in less than a day, a turnaround time that alarmed ETF tax lawyers. Most funds now insist bankers keep their money in for at least a single day. "The industry standard is 48 hours," says James Brown, who counsels fund companies on taxes at Ropes & Gray in New York.

Whether one day or two, the transactions may be vulnerable to an IRS challenge, says Jeffrey Colon, a tax professor at Fordham University School of Law in New York who's written about ETF taxation. One question the agency might want answered, he says: Does the bank have some independent reason for this investment? If not, Colon says, "the only reason you're doing this is to facilitate the avoidance of tax."

The answer to Colon's question depends on whom you ask. More than a dozen bankers, market makers, and fund managers who spoke on condition of anonymity say heartbeat trades aren't profitable enough for the banks to pursue for their own sake. (Banks can't get paid directly by fund companies for the trades.) Instead, these market participants say, banks do them to build goodwill with clients and win other, more lucrative business. Freddy Martino, a Vanguard spokesman, gives a different account. He says banks "enter into these transactions for their own independent business reasons," and Vanguard doesn't award them any additional business as compensation.

A few ETFs can't fully benefit from heartbeats, because the Securities and Exchange Commission restricts their ability to pick and choose which stocks to hand over to redeeming investors. In June, the SEC proposed a rule that would remove that restriction. Some in the industry took the proposal as an implicit endorsement of heartbeats. The SEC wrote that one reason for the change would be to allow funds to shuffle stocks "in a cost- and tax-efficient manner." The draft rule is still under consideration, and the SEC declined to comment on heartbeats.

What if Congress closed the loophole, ending not just heartbeats but ETFs' entire tax edge? "Without this provision, millions of American investors would face more frequent, sizable, and unanticipated tax bills," says Keith Lawson of the Investment Company Institute. But low taxes are just one of ETFs' selling points, and the funds are flourishing in countries that don't give them special treatment.

Robert Gordon, a tax expert at Twenty-First Securities Corp. in New York, says ETFs are among his favorite investments because the 1969 provision makes them tax-efficient. But he warns that by using heartbeats, ETF managers might draw policymakers' ire and lose the break. "It's a transaction that looks too good to be true," Gordon says. "This has gone too far, and it's going to be the straw that breaks the camel's back."

Source: Bloomberg data

Methodology: To identify heartbeat trades, Bloomberg Businessweek analyzed fund-flow data for 1,578 stock and mixed-asset ETFs on U.S. exchanges. The data was screened to find symmetrical inflows and outflows that occurred within five trading days of each other, were at least three times as large as any flows within the surrounding 40 days, represented more than 1 percent of fund assets, and met other criteria. Not every heartbeat pattern represents a maneuver to shed stocks without incurring taxes, but spot checks show almost all of them occurred in connection with portfolio changes and in years following stock-market gains. The screen identified only the most pronounced heartbeats and didn't count those that occurred in rapid succession or weren't significantly bigger than adjacent fund flows.

To calculate taxable gains avoided, Bloomberg Businessweek added up realized capital gains from in-kind redemptions from the most recent annual reports of 442 U.S. equity ETFs. To calculate the tax revenue impact, Bloomberg Businessweek estimated the share of ETFs held by U.S.-taxable investors using ETF ownership data from Deutsche Bank, Cerulli Associates, and Broadridge Financial Solutions, and foreign securities ownership estimates from the U.S. Treasury. The share of ETFs held for more than a year was estimated based on an iShares survey. The share of short-term capital gains was estimated based on a sample of U.S. mutual fund capital-gains distributions. Applicable tax rates were estimated by subtracting 2 percentage points from the top marginal rates on short-term and long-term capital gains.

Editors: Robert Friedman, Yue Qiu

With assistance from Tom Lagerman

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