

Exchange Funds: A Solution to Concentrated Wealth

The strong equity markets of recent years have created an enormous amount of concentrated wealth. Early investors, founders and employees of successful companies often find that their financial success rests on the fortunes of a single stock. They know that diversification is prudent, but how exactly can this be achieved?

One easy answer, of course, is to sell some of the highly-appreciated stock and diversify as the proceeds are reinvested. But this can present problems. First, the sale of low-cost-basis stock can create a substantial capital gains tax liability. Second, a founder or employee with a substantial stake may find it politically unacceptable or disadvantageous to the company to sell a large share of their holdings at any particular time.

A possible solution to this dilemma comes in the form of an investment vehicle known as an exchange fund.

What is an Exchange Fund?

An exchange fund (sometimes referred to as a swap fund) is a limited partnership in which all partners share a single problem: they each have a concentrated position in a highly-appreciated stock. By contributing shares of their highly-appreciated securities in exchange for interests in a partnership comprised of investors in similar situations, they can diversify their holdings without incurring immediate capital gains taxes. And, because contributing stock to an exchange fund is likely to keep the stock from being sold in the public markets for several years, corporate counsel and financial officers generally view these transactions favorably. In most cases, holders of restricted stock can invest in exchange funds, subject to approval by his or her corporate counsel. Some exchange funds accept cash investors or may require a portion of each investment to be made in cash. A cash investment in an exchange fund may satisfy a particular investment objective and/or wealth transfer need.

Exchange funds have been in existence for nearly 40 years, although there have been numerous legislative attempts to change the tax code that permits them. Tax-free, "like kind exchanges" of securities are, in fact, prohibited. But there is a provision in the tax code that allows such exchanges as long as the partnership (or fund) holds no more than 80% of its assets in "stock and securities". Since the cash and contributed securities within an exchange fund are generally stock and securities as defined in Treasury regulations, the fund sponsor must ensure that at each exchange fund closing, at least 20% of the fund assets are held in "Qualified Investments". These consist of a very limited range of less liquid investments that fall outside of the Treasury's definition of "stock and securities". To satisfy this requirement, exchange funds usually invest in private preferred operating units issued by real estate operating partnerships.

To attain the benefits of a tax-free exchange, partners must remain in the fund for at least seven years. At the end of seven years, partners may generally redeem all or a portion of their share of the partnership without triggering capital gains tax liability. Redemption policies vary. For example, some exchange funds distribute select stocks while others may distribute a pro rata portion of the fund's total marketable securities. A fund's distribution policy is an important consideration and investors should determine, in the context of their own investment needs, the likely composition of the holdings with which they might exit the fund. Investors should also review a fund's early redemption policy and their own projected liquidity needs, as redemptions prior to the stated lifespan of the fund can be costly.

It is important to note that an exchange fund is a tax-deferral mechanism, not a tax-elimination

scheme. Upon exiting the fund (after at least seven years) the investor has in essence transferred his original cost basis from a single stock to a portfolio of stocks. A sale of any appreciated stock out of this portfolio would trigger a capital gain.

Exchange fund sponsors may be large investment banks or independent investment management firms. Fiduciary oversight of investors' interests may be performed by the sponsor or an independent board of directors. Exchange fund participants must generally be accredited investors, and in some cases must qualify as 3(c)7 "qualified purchasers", with net investments of at least \$5 million (excluding home, closely-held business, etc.). Fees typically include a front-end load, and ongoing advisory, investor servicing and custody fees of 0.75% to 1.00% annually. Some include additional fees upon exiting or redeeming interests in the fund.

Portfolio Construction

Portfolio construction is especially important to an exchange fund because, in order to preserve the tax deferral, the manager will try to avoid selling any of the original holdings during the life of the fund. The best funds will have a clearly-stated investment objective and use sophisticated portfolio construction techniques to determine an appropriate universe of stocks eligible for inclusion in the fund. Selection criteria may include such characteristics as market cap, industry sector, and trading volume.

Some exchange funds are broadly based and others are more targeted. Many funds will be structured around a recognizable benchmark such as the S&P 500 or the NASDAQ 100. Some investors have stocks that may not be accepted into these portfolios, but are acceptable to exchange funds with other structures. In these cases, it is important that the investor understand

the objective of the portfolio and how stocks will be selected for inclusion in order to avoid receiving a portfolio of “junk stocks” in a fund that takes all comers.

When the fund sponsor has assembled a proposed portfolio and prospective investors have placed their assets into an escrow account, each investor receives an "inspection report" listing the stocks, cash, and Qualified Investments and the amounts that have been tentatively accepted. The investor has typically 3 to 5 business days to review the report and pull out of the fund if desired. Once the deadline has passed, the investment manager reviews the remaining portfolio to ensure that it is still in keeping with the investment objective and makes any necessary adjustments, after which the fund closes and the partnership is officially formed.

Concurrent to this portfolio construction process, the fund sponsor secures the required 20% Qualified Investments portion of the portfolio. Some funds use leverage to purchase the Qualified Investments while other funds require cash in addition to a stock contribution to provide a more conservative capital structure.

Both methods of funding, leveraging and raising cash from investors, have advantages and disadvantages. Whether within the fund or outside the portfolio, borrowing funds has associated costs. While leverage can have a favorable effect in robust times, it can magnify a pronounced decline in the markets – a particularly acute concern for investors in portfolios of more aggressive, non-dividend-producing stocks.

Benefits of Investing in an Exchange Fund

Low-Cost Diversification: The risk of accumulating and holding much of your wealth in a single concentrated stock position is that

your financial health and independence rest largely upon the fortunes of the issuing company. While many have accumulated great wealth as the company they've founded or invested in achieved rapid success, many have also seen that wealth cut in half, or more, on bad news or a market sector downturn. Diversification can dramatically reduce this risk. Studies have shown that the odds of a single stock outperforming a diversified portfolio over a long-term timeframe are as low as 25%. In addition, the Qualified Investments tend to dampen the impact of a volatile market. An exchange fund, with its tax-deferral mechanism, provides a means to achieve immediate diversification without incurring a current capital gains tax liability.

Estate Planning: For investors wishing to make gifts to children or others, an attractive feature of a properly structured exchange fund is its estate planning benefits. They are particularly compelling for donors who prefer that the gift remain illiquid and inaccessible for distribution to the recipients for seven or more years, with the ultimate distribution consisting largely of a portfolio of securities rather than cash.

The lack of liquidity and control of exchange funds means that in the valuation of the gift, an investment in the fund would normally be valued at a discount to face value for tax purposes. Such discounts are likely to be in the 15% to 40% range on gifts made in the first year of a fund's existence. (The exact amount must be determined by each investor's tax advisor.) Thus, a \$1,000,000 gift might be valued at \$700,000 for tax purposes. At a marginal gift/estate tax rate of 40%, this \$300,000 reduction could result in a tax savings of \$120,000 at the time of gift, plus whatever taxes are saved as a result of getting the appreciating assets out of one's estate.

Some exchange funds offer a potentially more powerful feature for gifting purposes, an Estate

Freeze option. A gift made using this option would be expected to have far less value attributed to it for tax purposes than an outright gift of interests. When an investor elects the Estate Freeze option, his or her interests in the fund are each divided into a preferred component and a common component. The investor generally retains the preferred interests and gifts the common interests. Any return over the stated preferred rate of return allocated to the preferred interests is allocated to the common interests. The common interests may be treated as having very substantial discounts because they have lower initial value, greater uncertainty of return and even less liquidity and control than undivided interests. The investor and recipient may be subject to a longer-term commitment beyond the initial seven-year period.

Risks Associated with Exchange Funds

Exchange funds work well to transfer the risk of a single stock holding to that of a diversified portfolio, and provide attractive estate planning features. But investors should be aware of the potential risks.

Investment Risk: There is no guarantee that at the end of the fund's life cycle it will have outperformed the single stock originally contributed by an investor. In fact, by definition, some of the contributed securities will outperform the fund as a whole.

Illiquidity/Potential Tax Liability: The substantial tax advantages of participating in an

exchange fund result from the minimum seven-year lock up period of the assets. Any situation requiring the fund to sell or distribute a contributed security prior to seven years (e.g., the security is subject to a tender offer, a partner is granted a redemption due to divorce, etc.) will trigger a taxable event. The contributing shareholder generally bears the greatest burden, capital gains tax on the appreciation prior to contributing the stock to the fund. All shareholders bear a proportional tax liability for the stock's appreciation from the time of contribution. In addition, there is no secondary market for exchange fund investments.

Legislative: There is always the possibility of a change in the tax code, Treasury regulation, and their interpretations that could significantly alter the tax treatment of exchange fund investments, redemptions and distributions. Such changes could be retroactive, although it is commonly believed that retroactive treatment is unlikely.

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An investment in an exchange fund is not necessarily the solution to every concentrated wealth issue and may not be appropriate for every investor. But for those investors with a long investment time horizon who are seeking low-cost diversification, more flexible tax planning, and potentially powerful wealth planning and asset transfer benefits, an exchange fund can provide complementary characteristics to an overall diversified investment strategy.