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Planning Ideas—Exchange Funds

Many affluent and high-net worth clients face a common problem. They are business owners or corporate executives with concentrated positions in a single appreciated stock. Outright sale of low basis, highly-appreciated stock can be unattractive from a tax perspective. Under ATRA 2012, capital gains taxes can be as high as 23.8 percent for high-income earners.

Advisors have an arsenal of strategies to help these clients. Equity collars and prepaid variable forward contracts involve hedging the client's stock position to limit potential losses. Another strategy involves contributing the stock to a charitable remainder trust (CRT), which then sells the stock, reinvests in a diversified portfolio, and pays the donor an income stream.

An often overlooked alternative to selling the stock is an exchange fund. Basically, an exchange fund is an investment structured as a limited partnership or limited liability company that facilitates the tax-free exchange of securities for shares in a partnership. The partnership invests in a diversified portfolio.

Background

Exchange funds have been around for nearly 40 years, although there have been numerous legislative attempts to change the tax law that permits them. As a general rule, the exchange of securities for other securities is not tax free. An exception applies in the case of an exchange of securities for interests in a “regulated investment company.” A regulated investment company includes a partnership that holds no more than 80 percent of its assets in "stock and securities.”

Because the cash and contributed securities within an exchange fund are generally stock and securities as defined in Treasury regulations, the fund sponsor (usually a large bank or investment company) ensures that at each exchange fund closing, at least 20 percent of the fund assets are held in “Qualified Investments,” consisting of a limited range of less liquid investments that fall outside of the Treasury's definition of "stock and securities.”

Exchange funds often satisfy this requirement by purchasing operating units in specialized real estate partnerships. Some funds use leverage to purchase these units, while others require investors to contribute cash in addition to their stock.

Like hedge funds and other unregistered securities, exchange funds are generally only open to "qualified investors" with a liquid net worth of at least $5 million and, in many cases, an annual income of $200,000 or more for the past two years. Most exchange funds also require a minimum investment of $1 million in stock, although a few require substantially more.

How it Works

The partnership interest (or LLC membership) acquired in the exchange retains the same basis as the contributed stock. Such interest has limited marketability and liquidity; however, provided the client holds the interest for seven years, the interest can be redeemed tax free for a diversified portfolio equal to the value of the partnership interest as reflected in the partnership's underlying assets.

This diversified portfolio continues to retain the basis of the stock originally contributed to the partnership. The sale of securities making up the diversified portfolio by the client will result in capital gain.

It's important to note that the exchange fund is not a tax avoidance strategy, but rather a tax-deferral strategy.

Other Considerations

Decisions about portfolio construction are left to the fund manager's discretion. Some exchange funds are broadly based and others are more targeted. Many funds are structured around a recognizable benchmark such as the S&P 500 or the NASDAQ 100.

When investors leave an exchange fund they do not receive a cash distribution. Instead, they receive individual stocks. Depending on the fund, the distribution may consist of a pro rata share of all stocks held by the fund, or only a handful of specific fund holdings.

Despite their benefits, exchange funds do not protect investors against broad market declines. Furthermore, exchange funds are not a good choice for investors seeking dividend income since most exchange funds reinvest dividends in the fund.

Another drawback is liquidity. In order to achieve tax deferral, investors often must remain in the fund for at least seven years before redeeming their partnership or LLC interests. This liquidity problem is compounded by the fact that exchange funds do not trade on secondary markets, and often limit investors to monthly or even quarterly redemptions.

Exchange funds can also be expensive. In addition to charging an initial placement fee of one to two percent of the contributed share's value, an annual management fee of around one percent of fund assets is assessed. A few funds also charge additional fees when investors leave the fund.

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. These 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 percent to 40 percent range on gifts made in the first year of a fund's existence. Thus, a $1,000,000 gift might be valued at $700,000 for tax purposes. At a marginal gift/estate tax rate of 40 percent, 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 shifting the appreciating assets out of the donor’s estate.

Bottom Line

Exchange funds are not for everyone, but with both the equity market and capital gains tax rates going up these funds deserve a look. For the right client they offer a way to defer taxes, and a tax deferred is a tax saved.

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