EXCHANGE FUND

Explore how an exchange fund allows an investor with a concentrated equity position to invest in a more broadly diversified portfolio of stocks.

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"An exchange fund is a private placement in which numerous investors place their holdings in return for a limited partnership interest in the fund that results from all the contributions."

An exchange fund allows an investor with a concentrated equity position to invest in a more broadly diversified portfolio of stocks without incurring immediate capital gains taxes. By contributing the appreciated stock to an exchange fund, the investor can achieve the benefits of diversification without having to sell the shares.

How It Works

You exchange your concentrated stock position for a diversified portfolio made up of stock contributed by other investors in similar situations. This diversified portfolio, called an exchange fund, is a private placement in which numerous investors (who must meet certain qualifying standards) place their holdings in return for an interest in the fund that results from all the contributions. Even restricted stock contributions may be accepted. The exchange fund must also invest at least 20 percent of its portfolio in "qualifying assets" in order to meet the requirements for special tax treatment. Qualifying assets typically consist of real estate, real estate partnerships and commodities. The funds will often acquire these investments by borrowing against the value of the partnership assets.

Exchange funds are generally passively managed. To achieve non-recognition of gain or loss on the contribution, Federal requirements are for a holding period of seven years. It you make a withdrawal before that time, you will likely face early withdrawal penalties assessed by the fund, as well as potentially realizing capital gains. Therefore, you should typically consider an exchange fund only when you can comfortably commit to leaving your contribution in the fund for the long term.

At the end of the specified holding period (typically at least seven years), you can redeem your limited partnership interests for a diversified basket of securities chosen by the portfolio manager.

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Upon exiting the fund (after at least seven years), you have essentially transferred your original cost basis from a single stock to a portfolio of stocks. A sale of any appreciated stock from this portfolio would trigger a capital gain.

Like other unregistered securities, exchange funds are generally only open to 3(c)7 “qualified purchasers” with a liquid net worth of at least $5 million. While all exchange funds share certain features, different exchange funds may have distinct investment profiles and may differ in terms of their qualifying asset strategies, shareholder redemption rights, investment minimums, distribution policies, commissions and expenses. Exchange funds may also be distinguished by the experience and record of their sponsors as exchange fund managers.

Advantages

- Diversification
- Tax-free exchange
- Not a constructive sale
- May accept restricted shares

Disadvantages

- High expenses
- Not usually available for holdings in small or thinly-traded illiquid companies
- Loss of voting rights
- Very little or no income during holding period
- Limited liquidity
- Redemption fee on early withdrawals
- Potential adverse securities selection by fund manager
- May have to pay tax when no cash distributions are provided
- Potential tax code changes

FOR MORE INFORMATION

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