RESEARCH MEMO

Exchange Funds

A tool that solves the concentration permanently and the tax problem only conditionally

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Framework memo. Illustrative throughout; no client facts are described. Partnership and estate tax treatment are legal determinations and the analysis here is general. Nothing is tax or legal advice.

1 · SUMMARY OF CONCLUSIONS

An exchange fund is usually described as a way to diversify a concentrated position without paying tax. That description is accurate as far as it goes, and it stops at the point where the interesting questions begin.

The structure does two separate things, and they resolve differently. It solves the concentration, permanently and completely, because what comes back at the end is a diversified basket rather than the original shares. It does not solve the tax. The embedded gain carries through the whole arrangement and emerges at redemption attached to the basket instead of to the single position.

> The fund converts a concentrated tax problem into a diversified one. Whether that conversion is worth seven years of illiquidity, a fee, and an exposure the client did not select depends almost entirely on what happens at the end, and specifically on whether the client is still alive when it does.

Findings

1 · The deferral becomes elimination only at death. An investor who redeems during life receives securities carrying the original low basis. An heir who inherits the interest and then redeems receives the same securities at a stepped-up basis. Identical mechanism, opposite outcome, and the difference is who is holding the interest when the redemption occurs. (§4)

2 · The concentration is genuinely resolved, which is worth more than it is usually credited for. A low-basis diversified basket can be harvested, gifted selectively, and unwound position by position. A low-basis single holding allows none of that. Even where the tax is only deferred, the client ends with a materially more manageable problem than they started with. (§3.3)

3 · The illiquid asset requirement is not incidental, and the client owns the result. The structure depends on the partnership not being treated as an investment company, which is achieved by holding a meaningful allocation to assets such as real estate or commodities. That allocation is part of the client's exposure for the life of the fund, and it is rarely what they would have chosen. (§2.2)

4 · Ask the sponsor about the partnership's basis election before contributing. The estate step-up applies to the partnership interest automatically. It does not reach the fund's own basis in its holdings unless a section 754 election is in place. Where it is not, an heir can be allocated gain on appreciation that occurred before they inherited. This is a question with a specific answer and it is almost never asked. (§5)

5 · The right client is narrow and identifiable. Someone who cannot sell the position and cannot build around it, who intends to hold to death for the basis adjustment, and who wants the risk diversified in the meantime. For that client the structure does something nothing else does. Outside it, cheaper tools generally reach the same place. (§6)

Three standing rules

1. **Establish the terminal disposition first.** The entire value of the structure turns on whether the interest is held to death, and that question is answerable before any sponsor is contacted.
2. **Treat the lock-up as absolute.** These interests carry transfer restrictions and have no meaningful secondary market. A client who may need the capital should not be in one.
3. **Price the exposure you are accepting, not only the one you are leaving.** The pooled portfolio and its illiquid sleeve are the client's allocation for the duration, and they should be evaluated as such rather than treated as a technicality of the structure.

What would change these conclusions

- **Removal of the basis adjustment at death.** The structure's best outcome disappears and it becomes a deferral vehicle carrying a seven-year lock, which is a much weaker proposition.
- **A client with high basis.** There is little to defer, and selling is faster, cheaper, and completely certain.
- **Evolution in the structures themselves.** Newer vehicles have appeared using different qualifying assets and different minimums. The framework here is general; the specific terms of any particular fund should be read rather than assumed.

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2 · HOW THE STRUCTURE WORKS

2.1 The contribution

An exchange fund is a partnership. Investors contribute appreciated securities and receive partnership units representing a proportional interest in the pooled portfolio. Under section 721, no gain is recognized on a contribution of property to a partnership in exchange for an interest in it.

The basis follows. Under section 722, the investor's basis in the partnership interest equals their basis in the contributed stock. Nothing has been eliminated; the low basis has moved from the shares to the units.

Access is restricted. Traditional sponsors generally require qualified purchaser status, which carries a substantially higher threshold than accredited investor status, along with meaningful minimum contributions.

2.2 Why the fund holds real estate

Section 721 does not apply where the partnership would be treated as an investment company. A partnership holding nothing but marketable securities would fall into that category, and the contribution would be a taxable exchange.

The structure therefore holds a meaningful allocation to qualifying illiquid assets, commonly real estate or real estate partnership interests, and in some funds commodities. The allocation is frequently described as a technical requirement, which understates its significance to the investor.

> The illiquid sleeve is part of the client's portfolio for the life of the fund. They are not holding a diversified equity basket. They are holding a diversified equity basket plus leveraged real estate they did not select, managed by someone they did not choose.

Whether that is acceptable depends on the client's broader allocation. For some it is incidental or even welcome. For a client who already carries substantial real estate exposure elsewhere, it compounds a concentration rather than reducing one, and that should be checked rather than assumed.

2.3 The lock-up and the redemption

Investors must generally hold the interest for seven years before redeeming. At redemption the distribution is made in kind: the investor receives a pro-rata basket of the fund's securities rather than cash, because a cash payment would be a taxable event and would defeat the arrangement entirely.

The original shares do not come back. What comes back is a slice of the pool, which is the point.

3 · WHAT THE STRUCTURE ACTUALLY DELIVERS

3.1 The risk problem is solved

This deserves to be stated plainly because discussions of exchange funds concentrate so heavily on tax that the primary benefit gets treated as secondary. The client contributed a single security and receives a diversified basket. The idiosyncratic risk of the original holding is gone and does not return.

For a client whose concentration genuinely threatens their financial plan, and who has no other route to reducing it, that alone can justify the structure.

3.2 The tax problem is deferred

The basis carries through the entire arrangement. From the contributed shares to the partnership interest under section 722, and from the partnership interest to the distributed securities at redemption. An investor who redeems during their lifetime holds a diversified basket at the same aggregate basis their original position carried.

No tax has been paid, and no tax has been avoided. It has been postponed for at least seven years, which has genuine value, and it has been detached from a single security.

3.3 The deferred problem is better than the original one

A point worth making explicitly, because it is the strongest argument for the structure available to a client who will not hold to death.

A low-basis concentrated position is difficult to unwind. Every sale realizes gain at the same rate, there are no lots to select among that differ materially, and the position cannot be reduced without recognizing a proportional share of the embedded gain.

A low-basis diversified basket is a different situation. Positions can be sold individually, losers can be harvested to offset winners, individual holdings can be gifted or donated, and the whole thing can be unwound over years with far more control. The gain has not shrunk, but the client's ability to manage it has improved substantially.

4 · THE STEP-UP, AND WHO IS HOLDING THE INTEREST

The structure's best outcome and its ordinary outcome run through the same mechanism, and the distinction is simply timing.

4.1 Redemption during life

The investor's basis in the partnership interest is the carryover basis from the contributed stock. On a liquidating redemption, that basis is allocated to the distributed securities. The client receives a diversified basket carrying their original low basis, and tax is owed whenever those securities are eventually sold.

Deferral achieved. Nothing eliminated.

4.2 Death before redemption

The partnership interest is property included in the estate, and it receives a basis adjustment to fair market value at death under section 1014. The heir now holds an interest with a stepped-up basis.

When the heir redeems, the same allocation rule applies, and the stepped-up basis is allocated to the distributed securities. The heir receives a diversified basket at a basis close to its value, and the gain that accumulated over the original owner's lifetime is never taxed.

> The mechanism is identical in both cases. What differs is the basis in the interest at the moment of redemption, and death is what resets it. The structure's headline benefit is therefore not deferral. It is deferral that may become elimination, conditional on the client dying before the fund pays out.

Stated that bluntly it sounds grim, and it is the honest version. A client should understand that they are entering an arrangement whose principal tax advantage accrues to their heirs rather than to them.

5 · THE ELECTION NOBODY ASKS ABOUT

One complication sits between death and redemption, and it is worth raising with a sponsor before a client contributes.

The step-up at death applies to the partnership interest. It does not automatically apply to the partnership's own basis in the securities it holds. Under section 743, the basis of partnership property is not adjusted on the death of a partner unless a section 754 election is in effect.

Where no election is in place, the fund continues to hold its assets at their original low basis. If the fund sells securities while the heir is a partner, the heir is allocated gain computed on that low basis, including appreciation that occurred before they inherited. Their own basis in the interest increases by the gain allocated to them, so the effect partly reverses at redemption, but they have paid tax earlier than they otherwise would have.

How much this matters depends on two things: how long the interest is held between death and redemption, and how actively the fund trades its portfolio. A short gap and a passive portfolio make it immaterial. A long gap and an active one do not.

The practical instruction is narrow and useful. Ask whether the partnership has made a section 754 election, and ask before contributing rather than after. The answer is a fact about the fund, it is knowable, and it is not something most prospective investors think to raise.

6 · WHO THIS FITS

The structure is expensive, illiquid, and restrictive, and it earns its place only in a reasonably narrow set of circumstances. Those circumstances are identifiable in advance.

The position cannot be sold. Either the embedded gain is large enough that recognition is genuinely prohibitive, or the client's annual gain capacity is too small to unwind the position in any reasonable period.

The position cannot be built around. There is no new capital arriving, no basis dispersion to exploit, and no other assets to construct a complement from. The separately managed account route has been assessed and the inputs are not there.

The client intends to hold to death. This is the condition that converts the structure from a deferral into an elimination, and without it the arrangement is considerably less attractive.

The client wants the risk reduced in the meantime. This is the piece nothing else provides. A client holding to death can simply hold, but then they carry single-name risk for the remainder of their life. The exchange fund removes that risk while preserving the basis adjustment, and no other tool does both.

That combination is the case for the structure, and it is a real one. A client who satisfies all four is not well served by any of the alternatives.

Where it does not fit

A client who may need liquidity. A client with high basis, for whom selling is cheaper and faster. A client who will sell within the seven-year window regardless, who will have paid fees and surrendered control to arrive at the same tax position. A client who already carries substantial real estate exposure, for whom the illiquid sleeve compounds rather than diversifies. And a client who has not been told that the primary tax benefit belongs to their heirs.

7 · LIMITATIONS

Terms vary and this memo does not read them. Lock-up periods, minimums, qualifying assets, fee structures, and redemption mechanics differ across sponsors, and the general description here should not substitute for the offering documents.

Fees are not modeled. These carry costs well above an index fund, and over seven years that drag should be set against the deferral benefit explicitly.

The partnership and estate tax interaction is complex. The treatment described in §4 and §5 is the general framework. How it applies to a specific fund, a specific estate, and a specific redemption is a question for tax counsel, and the amount riding on the answer justifies asking.

The market has evolved. Newer structures have appeared with different access requirements and different qualifying assets. Whether they achieve the same treatment is a question worth asking of each one rather than assuming from the category.

Framework memo prepared for illustrative purposes. Not tax or legal advice. Partnership contribution treatment, investment company characterization, basis adjustments at death, section 754 elections, and the tax consequences of redemption are legal determinations that depend on the specific structure and on individual circumstances, and should be confirmed with qualified tax counsel before any contribution is made.

Part of a Series

This memo is one of a set on concentrated positions. The framework that determines which tool applies is in Concentrated Positions.