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Am I the Only Person Paying Taxes? The Largest Tax Loophole for the Rich - Exchange Funds

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ABSTRACT

President Obama is faced with a national debt at over $11 trillion and needs to fund projects such as National Health Care with an ever-shrinking tax base. As the economy has slowed, so have tax revenues. It would then

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make sense for the government to reexamine tax carve-outs that only benefit the wealthy. In fact, President Obama is on record saying he wants to eliminate tax loopholes. After almost fifty years, the time is ripe to eliminate one of the few congressionally authorized tax loopholes—the $30 billion Exchange Funds.

This Article addresses the social equity arguments and the tax and economic theories to solve the perceived problem. The Article thoroughly covers, through unique access to materials not available in traditional legal sources, including fund private placement memorandum, the basics of fund details, fund formations, and the tax rules, and suggests solutions to solve the social inequity.

This Article not only proposes how to create legislation to tax the current arrangements but offers a solution utilizing the Code and Regulations to tax these vehicles.

INTRODUCTION

One of the longest periods of unchecked corporate and individual greed and excess has just ended.[1] The result of that greed is that our economy has gone through a recession.[2] During this past cycle, there has been a focus on the evils done by "Wall Street" to "Main Street" Americans.[3]

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1. *See generally* Landon Thomas, Jr., *Rich Britons, Offshore and Lightly Taxed, But Maybe Not Forever*, N.Y. TIMES, Aug. 7, 2009, at B1 ("[M]uch as Stephen A. Schwarzman, the chairman of the Blackstone Group, epitomized Wall Street's own era of excess."); Philipp Meyer, *American Excess: A Wall Street Trader Tells All*, INDEP. (U.K.), Apr. 27, 2009, *available at* http://www.independent.co.uk/news/world/americas/american-excess--a-wall-street-trader-tells-all-1674614.html; Dana Milbank, *Auto Execs Fly Corporate Jets to D.C., Tin Cups in Hand*, WASH. POST, Nov. 20, 2008, at A3 ("Instead, the chief executives of the Big Three automakers opted to fly their company jets to the capital for their hearings this week before the Senate and House—an ill-timed display of corporate excess for a trio of executives begging for an additional $25 billion from the public trough this week."); James Grant, Op-Ed., *The Fed's Subprime Solution*, N.Y. TIMES, Aug. 26, 2007, *available at* http://www.nytimes.com/ 2007/08/26/opinion/26grant.html.

2. *See generally* Robert Creamer, *AIG Bonus Scandal Spotlights the Bankruptcy of Wall Street's "Greed is Good" Values*, HUFFINGTON POST, Mar. 15, 2009, http://www.huffingtonpost.com/robert-creamer/aig-bonus-scandal-spotlig_b_175124.html ("In 1987 Michael Douglas starred in a film called *Wall Street* where he famously intoned: 'Greed is good.' That has been the motto of the American financial sector for the last thirty years—and it became the accepted moral frame for much of American economic and political dialogue—culminating in the 'markets uber alles' philosophy of the Bush years."); Nouriel Roubini, Op-Ed., *A Global Breakdown of the Recession in 2009*, FORBES, Jan. 15, 2009, *available at* http://www.forbes.com/2009/01/14/global-recession-2009-oped-cx_nr_0115 roubini.html.

3. Although the current economic crisis has encompassed the collapse of many institutions, such as Lehman Brothers, and required an unprecedented governmental bail-out of others, the focus of the corporate greed has been directed at AIG. From the bonuses paid after the receipt of governmental bail-out money to the lavish corporate outings, AIG has

What has been shown is that there are bundles of benefits or "accumulative advantage[s]"[4] that exist for the wealthy that do not exist for the "average American" and that do not benefit the greater good. The tax code not only promotes these advantages, but also helped to fuel the over-consumption that led to the recent economic downturn.[5]

There can be no better example of unnecessary benefit without a corollary purpose than "exchange or swap funds."[6] An exchange or swap fund

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been a microcosm of the frustration. For information on the collapse of Lehman and other financials, see Graeme Wearden, David Teather, & Jill Treanor, *Banking Crisis: Lehman Brothers Files for Bankruptcy Protection*, GUARDIAN (London), Sept. 15, 2008, *available at* http://www.guardian.co.uk/business/2008/sep/15/lehmanbrothers.creditcrunch; Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sept. 14, 2008, at B1, *available at* http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all.

For information on bail-out money to U.S. companies, see Joseph R. Szczesny, *The Auto Bailout Keeps Growing, and Growing*, TIME, Jan. 14, 2009, *available at* http://www.time. com/time/business/article/0,8599,1871519,00.html; Peter Whoriskey, *Under Restructuring, GM to Build More Cars Overseas*, WASH. POST, May 8, 2009, at A1.
For information on the AIG corporate outing, see Andrew Taylor, *AIG Execs' Retreat After Bailout Angers Lawmakers*, USA TODAY, Oct. 7, 2008, *available at* http://usatoday.com/money/economy/2008-10-07-3811831325_x.htm; *AIG, Spa*, CHI. TRIB., Oct. 8, 2008, *available at* http://www.chicagotribune.com/business/chi-aig-spa-081008-ht,0,460884. story.

For information on AIG bonuses, see Brady Dennis & David Cho, *Rage at AIG Swells as Bonuses Go Out: Fed Decided Payouts Couldn't Be Stopped*, WASH. POST, Mar. 17, 2009, at A1; Jonathan Weisman, Sudeep Reddy & Liam Pleven, *Political Heat Sears AIG: Obama Vows to Block Bonuses, But It May Be Too Late; Firm Pressured to Repay U.S.*, WALL ST. J., Mar. 17, 2009, at A1.

4. MALCOLM GLADWELL, OUTLIERS: THE STORY OF SUCCESS 30 (2008).

5. *See* Fareed Zakaria, *Worthwhile Canadian Initiative*, NEWSWEEK, Feb. 16, 2009, at 31, *available at* http://www.newsweek.com/id/183670.

6. *See* David Cay Johnston, *A Tax Break for the Rich Who Can Keep a Secret*, N.Y. TIMES, Sept. 10, 2002, at C1, *available at* http://query.nytimes.com/gst/fullpage.html?res=9E05E2DC1631F933A2575AC0A9649C8B63&sec=&spon=&pagewanted=1. Exchange Funds used to be open to anyone. However, through the amendments, Congress has limited the investment to qualified investors, specifically, those investors with over $5,000,000 net worth. *Id.*

> To meet the 1997 requirements, the operators of exchange funds must form partnerships that are not offered to the general public, only to qualified purchasers. Other tax and S.E.C. rules require that the partnerships be treated as private placements, rather than a public offering to investors, so no advertising is allowed and prospective investors must sign confidentiality agreements.
>
> Why limit qualified purchasers to people with $5 million in stocks and bonds? The rationale is that exchange funds are considered suitable only for people who do not need to touch the money for 7 to 15 years[—]in short, only for people wealthy enough to afford the risk of such a long-term investment. A lot of early withdrawals make the fund unmanageable.

Id.

enables investors with over $5 million net worth[7] and a large block of a single stock position (most often with a $1 million minimum value), to diversify the position without recognizing gain.[8] These exchange or swap funds are available to the rich—not just the super rich.[9] "Fewer than one in 1,900 Americans qualify for exchange funds according to current rules, said Professor Edward Wolff, a New York University expert on wealth."[10]

President Obama is on record stating his administration's position to crackdown on tax loopholes.[11] A logical target would be a $30 billion tax loophole. Currently, budget estimates are at $3.55 trillion[12] and the national debt is over $12 trillion.[13] The time is ripe to examine all tax loopholes—especially the $30 billion exchange fund tax break.[14]

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7. A shareholder must at the time of the purchase, be a "qualified purchaser" as defined in Section 2(a)(51)(A) of the 1940 Act and rules thereunder. 15 U.S.C. § 80a-2(a)(51)(A) (2006).

8. *See* Lee Sheppard, *Ruby Slippers: Combating Tax-Free Formations of Investment Companies*, 84 TAX NOTES 1699, 1699 (1999) [hereinafter Sheppard, *Ruby Slippers*]. *See also* Marvin A. Chirelstein, *Tax Pooling and Postponement – The Capital Exchange Funds*, 75 YALE L.J. 183 (1965).

9. *See* Sheppard, *Ruby Slippers*, *supra* note 8, at 1699 ("An investor has to have $10 million worth of shares to even talk to an investment bank about an equity swap. An investor need only have $1 million in shares to contribute to a swap fund. Swap funds are sold as private placements to small numbers of investors each of whose total assets exceed $5 million. Swap funds, therefore, are for mere millionaires, rather than multimillionaires.").

10. Johnston, *supra* note 6.

11. *See* Obama for America, *Barack Obama's Comprehensive Tax Plan*, http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf ("Our tax code is riddled with special interest loopholes that allow some corporations and wealthy individuals to avoid paying their fair share of taxes."). *See also* Kenneth R. Bazinet, *President Obama Takes Aim at Tax Loopholes, Offshore Tax Shelters*, May 5, 2009, http://www.nydailynews.com/news/politics/2009/05/04/2009-05-04_obama_announces_plan_to_close_tax_loopholes_.html; Lynnley Browning, *Obama Plan Leaves One Path to Lower Taxes Wide Open*, N.Y. TIMES, May 5, 2009, at A3, *available at* http://www.nytimes.com/2009/05/05/business/05shelter.html.

12. Roger Runningen & Hans Nichols, *Obama Says U.S. Long-Term Debt Load 'Unsustainable' (Update2)*, BLOOMBERG.COM, May 14, 2009, http://www.bloomberg.com/apps/news?sid=abXWfVxx_e8w&pid=20603037 ("The White House Office of Management and Budget also projected next year's budget will end up at $3.59 trillion, compared with the $3.55 trillion it estimated previously.").

13. *See* Lori Montgomery, *Deficit Projected To Swell Beyond Earlier Estimates: CBO Expects Trillions More in Borrowing*, WASH. POST, Mar. 21, 2009, at A01, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/03/20/AR2009032001820.html?hpid=topnews; U.S. National Debt Clock, http://www.usdebtclock.org/ (last visited Mar. 30, 2010).

14. *See* Montgomery, *supra* note 13 ("Tax collections, meanwhile, would lag well behind spending, producing huge annual budget deficits that would force the nation to borrow nearly $9.3 trillion over the next decade—$2.3 trillion more than the president predicted when he unveiled his budget request just one month ago."); Shira J. Boss, *Another Twist for Exchange Fund Loophole*, FORBES, Mar. 20, 2001, http://www.forbes.com/2001/03/20/0320finance.html ("'The [proposed] legislation rarely says, "There will be no more exchange

I. ACCUMULATED ADVANTAGE

The problem facing President Obama in his stated policy of eliminating tax loopholes is twofold. First, Congress has a long history of passing tax benefits without looking back to determine the applied effects of those benefits. Second, the modification to existing tax policy is typically reactionary and piecemeal; it is unable to keep up with the technology available in the financial products marketplace.

> It is those who are successful, in other words, who are most likely to be given the kinds of special opportunities that lead to further success. It's the rich who get the biggest tax breaks. It's the best students who get the best teaching and most attention. And it's the biggest nine- and ten-year-olds who get the most coaching and practice. Success is the result of what sociologists like to call "accumulative advantage."[15]

There are many who feel that our tax policy tends to promote this accumulated advantage by giving as many tax breaks or incentives to the wealthy as possible.[16] The policy generally is to encourage investment in an

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funds," Dowdall points out. "Instead you get amendments, or changes in the language or the definitions or the exceptions [that could effectively eliminate them].”’”).

15. GLADWELL, *supra* note 4, at 30.

16. *See* Johnston, *supra* note 6 ("It's all perfectly legal[—]but only if you have $5 million of stocks and bonds. And only if you promise to keep it secret. It's one example of how the tax laws currently grant certain favors only to the very wealthiest."). For example, among other items, capital gains are taxed at lower rates than ordinary income. *See, e.g.*, JOEL FRIEDMAN & KATHERINE RICHARDS, CTR. ON BUDGET & POLICY PRIORITIES, CAPITAL GAINS AND DIVIDEND TAX CUTS: DATA MAKE CLEAR THAT HIGH-INCOME HOUSEHOLDS BENEFIT THE MOST 2 (2006), http://www.cbpp.org/files/1-30-06tax2.pdf ("[O]nly [an estimated] 17 percent of households in the bottom 60 percent of the income spectrum own [some] stock in taxable accounts" while "73 percent of the households in the top 10 percent of the income spectrum own stock" and the "top one percent owns 29 percent of all taxable stock."). Home interest is deductible. *See* Zakaria, *supra* note 5 ("[T]he Canadian tax code does not provide the massive incentive for overconsumption that the U.S. code does: interest on your mortgage isn't deductible up north."). Tax-free exchanges of commercial property are permitted under § 1031. *See* Terry Pristin, *Commercial Real Estate; Money Flowing to New Way to Pool Buyers*, N.Y. TIMES, Sept. 22, 2004, at C10, *available at* http://query.nytimes.com/gst/fullpage.html?res=9D06E6D61239F931A1575AC0A9629C8B63 ("Under § 1031 of the federal tax code, such taxes can be deferred if the property being sold is exchanged for one of the same value. But the seller has to find a new property within 45 days and complete the exchange within 135 days after that—a deadline that sponsors say is often hard to meet, particularly in a hot real estate market."); Federation of Exchange Accommodators, *Professional Trade Association for Qualified Intermediaries Under IRC § 1031: FAQs*, http://www.1031.org/about1031/faq.htm (last visited Apr. 15, 2010) ("The theory behind Section 1031 is that when a property owner has reinvested the sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay any tax. In other words, the taxpayer's investment is still the same, only the form has changed (e.g. vacant land exchanged for apartment building). Therefore, it would be unfair to force the taxpayer to pay tax on a 'paper' gain.").

area that Congress deems to be beneficial.[17] It is accepted that tax policy that favors an investor class or a corporation is permissible because it benefits the greater economic good. One such advantage granted is the tax-free diversification commonly called exchange or swap funds, which was never enacted with the purpose of benefiting the greater economic good.[18]

Even if there is a greater economic good, it has been eloquently argued numerous times that providing this accumulated advantage through the tax code does not provide a greater good.[19] One problem in analyzing tax policy is the lack of follow-up research to determine whether or not the Internal Revenue Code of 1986, as amended (Code), is accomplishing its stated goals.[20] Often, it is the initial stated assumption that rules the day.[21] For example, the assumption with capital gains tax is that it will encourage investment by middle-class Americans even though this has been proven untrue.[22] More often than not, the applied results will greatly diverge.[23]

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17. For example, "clarinet and music lessons" are deductible. *See* Linda Stern, *Deduction Redux: Six Tax Breaks You've Probably Never Heard Of*, NEWSWEEK, Apr. 7, 2009, http://www.newsweek.com/id/192900?from=rss.

18. Generally, in a swap or exchange fund a single stock position is contributed to a partnership with other single stock positions. At the end of a term the contributor receives back a diversified portfolio of positions. *See* Johnston, *supra* note 6; Boss, *supra* note 14. This Article does not address the reporting rules under Rule 144, Section 16 or 13(d) of the Exchange Act. The funds leave it up to the shareholder whether this constitutes a disposal worth reporting on schedule 13D or 13G filings. *See* Beldore Capital Fund LLC, SUMMARY OF THE TERMS OF THE OFFERING 54 (2007) [hereinafter Beldore].

19. See, for example, discussions centered around the home interest deduction for a home owner's mortgage. In a recent article by Mr. Fareed Zakaria in *Newsweek*, he posited that there is no actual correlation between the tax benefit and home ownership. He compared Canada's taxing system to the United States regarding home interest deductibility. In Canada, interest is not deductible while it is in the United States. Zakaria, *supra* note 5 ("Ah, but you've heard American politicians wax eloquent on the need for these expensive programs—interest deductibility alone costs the federal government $100 billion a year—because they allow the average Joe to fulfill the American Dream of owning a home. Sixty-eight percent of Americans own their own homes. And the rate of Canadian homeownership? It's 68.4 percent.").

20. *See, e.g.*, FRIEDMAN & RICHARDS, *supra* note 16 ("There is little evidence, however, that these tax cuts have had a positive impact on the stock market. A recent study by three Federal Reserve economists found that these tax cuts did not raise the value of U.S. stocks. Similarly, an analysis by the Urban Institute-Brookings Institution Tax Policy Center found that capital gains tax rates and stock market values have been only weakly correlated over time.").

21. *See, e.g.*, Sheppard, *Ruby Slippers*, *supra* note 8, at 1699 ("[Rep.] Neal's bill also asks the larger question of why listed securities should ever pass tax-free in a section 351 transfer.").

22. *See supra* note 16.

23. *See, e.g.*, Gene Amromin, Paul Harrison & Steven Sharpe, *How Did the 2003 Dividend Tax Cut Affect Stock Prices?* 1 (Divs. of Research & Statistics & Monetary Affairs, Fed. Reserve Bd., Paper No. 2005-61, 2006), *available at* http://www.federalreserve.gov/

The purpose of this Article is not to attack the decisions of Congress to promote investment or other socioeconomic goals. Rather, there are portions of the Code that appear at odds with the stated policy of Congress.[24] This often occurs when the Code has been applied to structures to which it was not intended.[25] In the tax vernacular, this type of application is often referred to as "tax shelters" or "tax loopholes." When structures are established specifically to avoid a Code section, with tax avoidance as their primary motivation, they are universally attacked by Congress and the Internal Revenue Service (Service).[26]

When unintended consequences occur from an intended structure, the resulting anomaly is often cleared up with either legislation or rulings by the Service.[27] Perhaps, Congress should have enacted a "subjective" Code provision that merely stated that if the tax structure provided the economic benefit of diversification, it is taxable. This is similar to the subjective approach used by the "economic substance" criteria. However, what happens when the anomaly is not corrected but rather acquiesced to?[28] In the case of

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pubs/feds/2005/200561/200561pap.pdf (concluding that there was no finding of "any imprint of the dividend tax cut news on the value of the aggregate U.S. stock market").

24. The Service has promoted various theories to attack these anomalies. For example, the "economic substance doctrine" is used as a counter argument when the form of the transaction meets the rules but the substance of the transaction is lacking. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465, 469-70 (1935); Joseph Bankman, *Articles and Essays: The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000).

25. The tax shelters that unwound during the Enron period illustrate this point, including the famous "Son of Boss" transactions. In the "Son of Boss" transaction, an assets basis would be augmented through the partnership tax rules. *See* John D. McKinnon & Jeff D. Opdyke, *What Enron Means for Your Tax Return: IRS Crackdown Turns to Individuals in Wake of Accounting Scandals; Here's How to Respond*, WALL ST. J., Apr. 9, 2002, at D1, *available at* http://online.wsj.com/article/SB1018304490631111160.html ("Clearly, the IRS is saying 'We know you've been playing games,' and now they're out to stop it." (statement of tax attorney Stefan Tucker)). *See also* Press Release, IRS, Treasury Issues Guidance on Partnership Abuses (June 23, 2003), http://www.treas.gov/press/ releases/js493.htm (discussing the "Son of Boss" transactions).

26. *See* Sheppard, *Ruby Slippers*, *supra* note 8, at 1700 ("Greene Street's, uh, investment objectives show the overwhelming tax-avoidance motive of its formation."). S*ee also* Beldore, *supra* note 18.

27. For example, the IRS publishes lists of Abusive and Listed Transactions on their web site. IRS, Recognized Abusive and Listed Transactions, http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html (last visited Feb. 26, 2010). This is also a compilation of the most aggressive tax shelters. *See generally* McKinnon & Opdyke, *supra* note 25.

28. Boss, *supra* note 14 ("Technically, exchange funds should be illegal. There is a law preventing people from exchanging one security for a like security without paying taxes. There is also a general rule prohibiting investors from contributing securities to a partnership—which is what an exchange fund is—in exchange for shares in the partnership when the whole purpose is stock diversification."). For example, in I.R.S. Notice 2001- 45, 2001-33 I.R.B. 129 (Aug. 13, 2001), a similar basis shifting conceptual structure was disallowed by the Service. In the notice, the Service identified certain redemptions of stock in transac-

exchange or swap funds, there has been over fifty years of acquiescence. When a correction was proposed to this anomaly,[29] the Joint Committee on Taxation stated that the rich would just find another way to avoid the tax[30]—a rather strange position for the Committee to take.

II. EXCHANGE FUND BASICS

In our current economic environment, one would not think that a diversification technique employed since the 1930s would be important. However, the current downturn of the market has created an environment in which techniques that historically were viewed as neutral or good are now favored.[31] In reality, the downturn in the market has opened the market for

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tions not subject to U.S. tax in which the basis of the redeemed stock is purported to shift to a U.S. taxpayer as "listed transactions." *Id.*

29. Sheppard, *Ruby Slippers*, *supra* note 8, at 1699 ("[A] bill, H.R. 2705, [was introduced] to further amend section 351, this time in a broader way than has been done in the past, to combat tax-free formation of swap funds. Neal's bill also asks the larger question of why listed securities should ever pass tax-free in a section 351 transfer.").

30. Johnston, *supra* note 6, at C4 ("The Congressional Joint Committee on Taxation, without any supporting data, has written Mr. Neal to say that no revenue would be raised by closing exchange funds because 'the class of investors engaging in swap funds' would find other ways to avoid the tax.").

31. *See* Sheppard, *Ruby Slippers*, *supra* note 8, at 1699 ("In spite of, or perhaps because of, the warning signs of a market downturn, the formation of swap funds and the avoidance of gain recognition on the contribution of appreciated securities has continued apace."); Walter Updegrave, *Danger: High Levels of Company Stock: Owning Your Employer's Shares in Your 401(k) Is a Huge Threat to Your Retirement. Keep it to a Minimum*, MONEY MAG., Jan. 8, 2009, http://money.cnn.com/2009/01/07/pf/expert/company_stock.moneymag/index.htm ("The problem is that once you get beyond a small holding of company stock—or the shares of any one company for that matter—you dramatically increase the riskiness of your portfolio in two ways. First, you expose yourself to the possibility that your company may simply implode along the lines of Bear Stearns and Lehman Brothers, decimating the stock's value (and your 401(k)'s balance along with it) virtually overnight. But even if that doesn't happen, there's another risk: heightened volatility. A single stock is typically two to three times more volatile than a diversified portfolio."); Shlomo Benartzi with Richard H. Thaler, *Using Behavioral Economics to Improve Diversification in 401(k) Plans: Solving the Company Stock Problem*, UCLA ANDERSON SCH. OF MGMT, http://www.anderson.ucla.edu/x8065.xml (last visited Feb. 26, 2010) ("In the case of company stock, overconfidence could also be exacerbated by a 'familiarity bias.' When we know more about a company, we are more comfortable investing in that company, even if we have no real private information that would provide an investment advantage. . . . Many investors fail to realize that the investment performance of a single stock is much riskier than that of a diversified portfolio."); Paul J. Lim, *Diversify! Diversify! (Yes, Even Now)*, N.Y. TIMES, Dec. 7, 2008, at BU7, *available at* http://www.nytimes.com/2008/12/07/business/yourmoney/07fund.html ("Only over time does diversification really show its worth. For example, over the 10 years through November, the S.& P. 500 lost almost 1 percent a year, on average. But a diversified portfolio of 40 percent S.& P. 500 stocks, 25 percent foreign shares in the MSCI EAFE index, 25 percent in fixed-income securities found in the Barclays Capital U.S. Aggregate Bond Index, and 10 percent in Trea-

the exchange fund industry.[32] For example, in the middle of one of the worst times to invest in United States history, Eaton Vance closed another exchange fund in October 2008.[33]

"When most Americans sell stock they must pay taxes on their profits by the following April 15."[34] Exchange funds are sold to the wealthy as a means to diversify a single stock position without realizing current tax on that position.[35] Investors will receive immediate diversification of their po-

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sury bills gained nearly 2 percent annually, on average, according to T. Rowe Price."); Jane Bryant Quinn, *Diversify Your Investments Even If It Hurts: Jane Bryant Quinn*, BLOOMBERG.COM, Apr. 22, 2009, http://www.bloomberg.com/apps/news?sid=aX44el0YV2xk&pid=20601212 ("The best way to minimize your risk of investment loss is to own assets with low or negative correlations."); Alan R. Feld, *High Exposure To Low-Basis Stock: Too Much of a Good Thing?*, CPA J., Nov. 1999, at 60, *available at* http://www.nysscpa.org/cpajournal/d601199a.html ("Since even a 'typical' stock—a stock with an average arithmetic return close to the market's—misses out on the smoothing effect of diversification, it's likely to underperform the market as a whole. In fact (Table 1[]), between 1970 and the end of 1998, a $1 million investment in the average single stock was sufficiently volatile to fall $18 million short of a market portfolio over the 29-year period. Furthermore, this heightened volatility is exacerbated when the investment environment is more difficult than usual. The longer the bad patch, the more poorly the average stock is likely to perform relative to the market."). *See generally* Robert S. Bloink, *Premium Financed Surprises: Cancellation of Indebtedness Income and Financed Life Insurance*, 62 TAX LAW (forthcoming Spring 2010) (manuscript on file with the author).

32. *See* Sheppard, *Ruby Slippers*, *supra* note 8, at 1702 ("Congress can take comfort in the fact that like many troublesome transactions, the swap fund transfer is a bull market transaction. When the bear comes, there will have to be statutes to prevent the selective recognition, transmutation, and preservation of capital losses.").

33. Another example would be EBX IV, L.P., which closed at the end of 2008 with twenty-eight companies. EB Exchange Funds Home Page, http://www.ebexchangefunds.com (last visited Feb. 26, 2010) [hereinafter EB Exchange Funds].

34. Johnston, *supra* note 6, at C1.

35. *See, e.g.*, Sheppard, *Ruby Slippers*, *supra* note 8, at 1700; Beldore, *supra* note 18, at 3; Citigroup Alternative Investments, http://www.smithbarney.com/products_services/managed_money/cai/types.html (last visited Feb. 26, 2010) ("Exchange funds allow investors a tax-free means to diversify a low-cost-basis and/or restricted stock position. Exchange funds allow investors to pool their low-cost-basis stocks in a fund. In exchange for contributing their stock to the fund, each investor owns a pro-rata share of the fund. After a set period of time—generally seven years—investors can redeem their interest in the fund. They will receive a non-taxable, distribution of a diversified pool of stock from the fund's portfolio. The value of this distribution is equal to the net asset value of their pro-rata interest in the fund at the time of the distribution. The stock distributed from the fund will retain in the aggregate the low cost basis of the stock originally contributed to the fund. There is always the possibility that the U.S. tax code could change, disallowing the favorable tax treatment of exchange funds. These changes could be retroactive, although this is believed to be unlikely."); Wilmington Trust, Single Stock Diversification Strategies, http://www.wilmingtontrust.com/wtcom/index.jsp?fileid=3000192 (last visited Feb. 26, 2010) ("The goal of an exchange fund is to allow an investor to shift from a concentrated position to a diversified position without triggering capital gains tax, as would be the case if the investor simply sold shares.").

sitions.[36] At the end of seven years, that investor will receive a bundle of securities with the same cost basis as the single stock position he or she contributed to the fund.[37] Further, it is arguable whether this contribution is subject to the reporting rules, such as Rule 144.[38]

Nonetheless, how large could this small carve-out actually be? The largest Eaton Vance fund has over $16 billion under management.[39] A transformation of the law would have a minimum tax impact of over $3 billion on this fund alone.[40] However, there are similar funds at JP Morgan, Bessemer Trust, and Goldman Sachs, among a few.[41]

An interesting part of the discussion is the purported application of Sections 351 and 721 of the Code, discussed *infra*, to exchange fund forma-

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36. *See* Johnston, *supra* note 6, at C4 ("The confidential offering provided to The Times shows that investors have contributed to Eaton Vance's exchange funds pool shares of more than 700 corporations, including almost every company in the Standard & Poor's 500."); Boss, *supra* note 14.

37. *See* Boss, *supra* note 14 ("Seven years later, all the investors could withdraw a basket of stocks from the fund without paying capital gains."); Johnston, *supra* note 6, at C1 ("If investors stay in the pool for seven years, the stocks they get when they withdraw their investment do not incur the tax on investment profits that other investors must pay. Only if the investors then sell the various stocks they received from the pool are they supposed to pay taxes."); Toddi Gutner, *Time to Swap 'n' Save? Exchange Funds Can Postpone Your Tax Bill*, BUS. WK., Aug. 9, 1999, at 100, *available at* http://www.businessweek.com/1999/99_32/b3641125.htm.

38. *See* Johnston, *supra* note 6, at C4 ("One of these people said he was also upset by advice in promotional literature for the Eaton Vance funds that shows executives how to disclose these transactions in a way that is legal but that investors who track sales by company executives are less likely to notice.").

39. *See id.* ("The Eaton Vance mutual fund company in Boston and the Goldman Sachs investment house are by far the biggest operators of investment pools based on this tax avoidance technique, with at least $18 billion of stocks in what are known in the investment business as exchange funds or swap funds."); Boss, *supra* note 14 (estimating that in 2001, "more than $20 billion [was] tied up in exchange funds, according to industry accounts. Bessemer Trust's four funds alone house[d] over $1 billion of individual investors' stocks"). *See also* Ari Weinberg, *Founders Get a Cure for the IPO Blues*, FORBES, Sept. 13, 2002, *available at* http://www.Forbes.com/2002/09/13/0913funds.html.

40. The current long capital gains tax rates in 2009 is 15%. See Section 112 of the Code.

41. *See* Johnston, *supra* note 6, at C4 ("Smaller exchange funds are operated by investment firms that include the Bessemer Trust, Credit Suisse First Boston, Merrill Lynch and the Salomon Smith Barney brokerage unit of Citigroup."); Boss, *supra* note 14 ("Several major investment companies have orchestrated these funds, including JP Morgan (nyse: JPM - news - people), Goldman Sachs (nyse: GS - news - people), Eaton Vance (nyse: EV - news - people), Salomon Smith Barney, a unit of Citigroup (nyse: C - news - people), and Donaldson Lufkin & Jenrette, a unit of Credit Suisse First Boston. 'It's clearly targeting a certain profile of investor—that being the wealthiest,' Henderson says. Typically investors contribute a minimum of $1 million in appreciated stock, which represents 10% to 20% of their holding."); Gutner, *supra* note 37.

tion.[42] As anyone who remembers basic income tax can attest to, the utilization of these nonrecognition statutes[43] is surprising in light of basic income tax principles.[44] A typical Section 351 or 721 transaction is "a relatively small-volume transaction involving either the incorporation of an existing business by its owners or[, most commonly,] the establishment of a new business by a limited number of individuals desiring to combine their capital and skills."[45] The basic tax principle that applies to the contributions in these small start-up businesses is viewed as a mere change in form of conducting operations of holding property.[46]

For a shareholder to achieve the diversification that an exchange fund achieves, almost by definition, requires numerous shareholders since all shareholders are contributing single-stock positions. Exchange fund formations involve hundreds of shareholders.[47] In an exchange fund, each shareholder "in exchange for one or a few appreciated securities, obtains a fractional interest in a large diversified portfolio of which his former property is but a small part."[48] Most concerning is that these individuals are the wealthiest people who are not truly in need of this benefit.[49]

Moreover, the participants in an exchange fund are "brought together—perhaps 'assembled' is the better term—not by virtue of acquaintance, business contact or other element of previous association, but as a result of

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42. BORIS I. BITTKER & LAWRENCE LOKKEN, 4 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 91.2.2 (3d ed. 2003) ("This rule [351] is intended to preclude tax-free diversifications of investments by swap-fund exchange plans . . . .").

43. A basic discussion of tax principles will be helpful in understanding nonrecognition. The general rule is that a change in form of ownership of property will trigger tax. You will both realize the gain or loss and recognize the tax effects. The Code provides several exceptions to this rule. Although the gain is realized, the taxpayer does not recognize the gain or loss for tax purposes. Some common nonrecognition statutes are § 1031 for like-kind real estate transfers and the rules subject to this article.

44. Chirelstein, *supra* note 8, at 190.

45. *Id. See also* Treas. Reg. § 1.351-1(c)(7), Example (2) (as amended in 1996) (51 transferors of mixed bag of stocks treated as diversification); Rev. Rul. 99-5, 1999-1 C.B. 434.

46. This is commonly referred to as the aggregate view of partnership or corporate taxation.

47. For example, the Beldore fund anticipated over 100 shareholders. *See* Beldore, *supra* note 18, at 78.

48. Chirelstein, *supra* note 8, at 190.

49. Under the Investment Company Act, the shareholder has to be a qualified investor with over $5 million and shares must be offered to only accredited investors as defined in Rule 501(a) of Regulation D of the Security Act. *See* 15 U.S.C. § 80a-2(a)(51)(A) (2006) (noting that a qualified purchaser is defined as (i) any natural person who owns $5,000,000 or more in investments, (ii) any company that owns $5,000,00 or more in investments, (iii) any trust).

solicitation by promoters, brokers or fund management companies."[50] Then there is the issue of day-to-day control. "[T]he investors lack day-to-day control over management" activities and, of course, "have no individual management responsibilities" since the fund is held by thousands of investors.[51] In discussions regarding the intended uses of Section 351, a small, related shareholder group and active shareholder participation are normally referenced.[52] However, these characteristics are missing in the formation of an exchange fund.[53]

III. TRADITIONAL FUND STRUCTURE

Exchange funds were not the result of a specific grant of legislative authority. Rather, they were "an accidental development—that is, an accident of skillful planning—and not the product of a conscious legislative determination to extend relief to investors 'who feel prevented from diversifying because of what they consider to be the excessive tax cost of selling appreciated assets.'"[54] Therefore, the first question is: how are these funds traditionally structured. This is especially important because the tax effects that result are a derivative of the form of the fund.

An exchange fund is generally formed, by a promoter, as a Delaware limited liability corporation.[55] The limited liability interests in the fund are divided into shares.[56] The management, control, and operation of the fund are the exclusive responsibility of the manager of the fund.[57] The fund is managed by a board of directors that generally appoints an Investment Advisor.[58]

Shareholders have limited rights regarding their interest in the fund.[59] Often, the shareholders do not have the right to replace the promoter as the

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50. Chirelstein, *supra* note 8, at 190; *See also* BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2 ("[N]umerous unrelated individuals, solicited and selected by a promoter, transfer appreciated securities to a newly organized investment company in exchange for its stock.").

51. Chirelstein, *supra* note 8, at 190; *see also* Beldore, *supra* note 18, at 1.

52. Chirelstein, *supra* note 8, at 190.

53. *Id. See also* BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

54. Chirelstein, *supra* note 8, at 185 (quoting Prospectus of Centennial Management and Research Corp. 3 (Dec. 23, 1960)).

55. *See, e.g.*, Beldore, *supra* note 18, at 55.

56. Unlike a traditional small corporation strategy envisioned by Congress, "the [f]und may issue an unlimited number of full and fractional [s]hares." *Id.*

57. Compare this structure to the initial nonrecognition provisions under Section 351(e) as enacted. *See infra* Part IV. Generally speaking, nonrecognition treatment was proper when, immediately after the contribution, the persons transferring the stock were in control of the corporation. *See* Monte A. Jackel & James B. Sowell, *Transfers to Investment Corporations: Complexity in a Conundrum*, TAX NOTES 1659, 1660 (2002).

58. In the case of Beldore, the Investment Advisor is Boston Management and Research, a wholly owned subsidiary of Eaton Vance. Beldore, *supra* note 18, at 58.

59. *See* Beldore, *supra* note 18, at 55; Chirelstein, *supra* note 8, at 190.

manager of the fund.[60] Additionally, shareholders have limited rights to (i) "consent to . . . changes in the investment objective[s] and the fundamental investment [goals] of the [f]und"; (ii) designate a new investment manager if the initial investment goes bankrupt and the initial promoter does not appoint a successor; (iii) commence a shareholder derivative suit brought by a shareholder; (iv) voluntarily terminate the fund in the event that assets under management drop below a predetermined threshold; and (v) appoint a liquidator.[61] The most telling statement related to the shareholder rights is as follows from the Beldore fund prospectus, "[s]hareholders will have no right to vote on, consent to or approve any action or matter relating to the fund."[62] In sum, shareholders are wholly passive investors in the fund.

Since all decisionmaking authority vests in the manager, the manager of the limited liability company will play a crucial role. The manager is always the promoter of the fund.[63] The manager generally will turn over the investment decisions to the Investment Advisor.

The Investment Advisor will hold two important roles. The first role is as gatekeeper for the fund.[64] He or she will decide which securities are worthy of being part of the fund. The second role will be, after formation and close of the fund, as portfolio manager.[65] He or she will decide when and if any of the securities will need to be sold and if any investment techniques[66] will be employed by the fund.

Moreover, the manager charges significant investment management fees.[67] The fees charged have two components: (1) the initial fee and (2) the annual fees. Generally, these fees range from 1-2% of gross assets.[68]

It is a two-step process to be accepted into the fund. First, the investor must meet the initial vetting of the fund manager. Then the investor must meet the vetting of the other investors.

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60. *See* Beldore, *supra* note 18, at 55; Chirelstein, *supra* note 8, at 190.

61. *See* Beldore, *supra* note 18, at 55; Chirelstein, *supra* note 8, at 190.

62. Beldore, *supra* note 18, at 55.

63. In the case of Beldore, the Manager is Eaton Vance. *Id.* at 55.

64. *See, e.g, id.* at 5.

65. *See, e.g, id.*

66. Investment techniques include a plethora of derivative trading techniques. Beldore includes, for example:

> using hedging techniques such as the purchase of put options, equity collars (combining the purchase of put options and the sale of call options on the same equity securities), equity swaps, short sales of individual securities held, short sales of index or basket securities whose constituents are held in whole or in part, forward sales of stocks held and the sale of futures contracts on stocks and stock indices and options thereon.

Id. at 2.

67. *See, e.g, id.* at 15.

68. *See, e.g, id.* at 14-15. They charge 60 bps plus a service fee of 25 bps plus transfer agent fees. *Id.* at 15.

Generally, the process for vetting securities is as follows. The investor will speak with the promoter and describe the securities.[69] The promoter will then discuss with the Investment Advisor whether those securities meet the investment guidelines of the fund.[70] The securities will also generally come from the big three exchanges (e.g., NYSE, AMEX, NASDAQ) with minimum share pricing and capitalization.[71] If they are of the class of securities the Investment Advisor desires to balance the portfolio, then the fund will circulate the prospectus to the investor.[72] Often, funds have a general theme.[73] For example, in the 1990s there were funds for technology IPO offerings[74] or there were high-tech funds.[75]

If the securities meet the first test of acceptance by the Investment Advisor, then the shareholder will place the securities with an escrow agent "pending the exchange of the securities for [s]hares" in the fund.[76] The securities must meet the criteria of the other investors. Before the fund officially closes, there is an inspection period of generally three to five days after a list of the securities and other investments is circulated among the

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69. *See, e.g*, *id.* at 34.

70. *See, e.g*, *id.* *But cf.* Chirelstein, *supra* note 8, at 187 (noting that the acceptable securities were "included in the fund's prospectus").

71. For example, Beldore requires stock price to be at least $10.00 with "an equity market capitalization of at least $500 million." Beldore, *supra* note 18, at 5, 34.

72. *See, e.g.*, Beldore, *supra* note 18, at 5 ("Equity securities proposed for contribution to the Fund will be evaluated by the Investment Advisor and accepted or rejected based primarily upon the Investment Adviser's view of how acceptance of such securities would affect the Fund's ability to achieve its investment objective."); EB Exchange Funds, *supra* note 33 ("EB will review hundreds of companies before accepting stock of about 25 companies into a fund.").

73. David A. Twibell, *Understanding Exchange Funds*, FIN. ADVISOR, Nov. 2004, *available at* http://www.fa-mag.com/component/content/article/992.html?magazineID=1&issue=49&Itemid=73 ("'Some funds, like Eaton Vance's Belterra Fund, focus on building a portfolio of well-known large-cap stocks, while others like Merrill Lynch's Montvale Fund lean more toward the mid-cap market.' says Blake Flood, vice-president of investments at Atlanta-based Consolidated Planning Corp., an affiliate of Raymond James Financial Services. 'Other funds try to track major stock indices such as the Standard & Poor's 500 or the Nasdaq 100.'").

74. *See* Weinberg, *supra* note 39; EB Exchange Funds, *supra* note 33 (explaining that EB Exchange Funds create partnerships that enable entrepreneurs who are Accredited Investors to pool their pre-IPO stock).

75. *See, e.g.*, White v. Alex Brown Mgmt. Servs., No. D049385, 2008 WL 324739, at *2 (Cal. Ct. App. Feb. 7, 2008). White was one of the original founders and President of Qualcomm and contributed his highly appreciated stock to the DB Alexander Brown Exchange Fund I. *Id.* When the Fund closed it had eighty-eight partners who contributed $152.5 million of securities. *Id.* *See generally* Cabaniss v. Deutsche Bank Sec., Inc., 611 S.E.2d 878 (N.C. Ct. App. 2005).

76. *See* Beldore, *supra* note 18, at 7.

prospective investors.[77] During this inspection period, prospective investors can withdraw their subscriptions.[78]

The exchange fund units will usually be redeemable at any time.[79] If the redemption occurs within the first seven years following the contribution to the fund, the securities that the investor contributed will be distributed.[80] At the end of seven years, a basket of securities will be distributed to the investor.[81]

Despite the promises of the fund managers, investors maintain risk within the funds. In the late 1990s, exchange funds were quite popular among the tech industry.[82] Alex Brown was one of the largest purveyors of funds. At close of the fourth incarnation of the fund, eighty-eight investors contributed more than ninety different securities valued at over $150 million.[83] However, several years later, the value of the fund dropped substantially.[84] The problem that arose for the fund manager was the inability to protect against this downside risk. In most funds, the managers set up the

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77. *See, e.g.*, *id.* (stating that the inspection period is "close of business on the third business day after distribution to Subscribers of the Inspection Report."). *But see* Chirelstein, *supra* note 8, at 187-88 (describing an inspection period of three weeks: "The 'preliminary report' permits the depositor to form a judgment concerning the investment merits of the portfolio, and he may (without cost) withdraw the securities deposited by him on notification to the depository at any time within a period of three weeks following receipt of the report.").

78. *See, e.g.*, Beldore, *supra* note 18, at 7.

79. Section 704(c)(1)(B) of the Code provides that if appreciated securities contributed by a partner are distributed within seven years after the date of contribution to anyone other than the contributing partner, the contributing partner will generally recognize a gain in the year of the distribution. I.R.C. § 704(c)(1)(B) (2006). *See* Chirelstein, *supra* note 8, at 189; Beldore, *supra* note 18, at 10.

80. *See* I.R.C. §§ 704 (c)(1)(B), 737 (2006). *See also* Beldore, *supra* note 18, at 86 ("To avoid the recognition of taxable gains by Investors in the Portfolio that have contributed securities to the Portfolio (including the Company), the Portfolio will not distribute appreciated securities contributed by an Investor in the Portfolio to another Investor in the Portfolio during the first seven years following contribution of the securities unless the contributing Investor in the Portfolio has withdrawn from the Portfolio. Similarly, the Company will not distribute securities contributed by an Investor in the Company (including the Fund) to another Investor in the Company during the first seven years after contribution of the securities unless the contributing Investor in the Company has withdrawn from the Company. And further, the Fund will not distribute securities contributed by a Shareholder to another Shareholder during the first seven years following contribution of the securities unless the contributing Shareholder has withdrawn from the Fund."); *id.* at 10 (explaining that there will also be a termination penalty around one percent depending on the fund).

81. *See* Beldore, *supra* note 18, at 11.

82. Weinberg, *supra* note 39 ("Developed by San Francisco-based EB Financial Group, an exchange fund is essentially a private-equity fund exclusively for founders.").

83. White v. Alex Brown Mgmt. Servs., No. D049385, 2008 WL 324739, at *1 (Cal. Ct. App. Feb. 7, 2008); Cabaniss v. Deutsche Bank Sec., Inc., 611 S.E.2d 878, 879-80 (N.C. Ct. App. 2005).

84. *White*, 2008 WL 324739, at *1; *Cabaniss*, 611 S.E.2d at 880.

funds with collars[85] to "limit the upside and downside" potentials of the fund.[86] However, in the early years of the fund, the appreciation of certain positions caused the renewal price of the collars to be excessive.[87] The managers made the decision to remove the collars and capture that initial gain.[88] Ultimately, the stocks experienced a sharp decline and, without the collar, a majority of the value of the exchange fund was lost.[89]

IV. TAX HISTORY OF EXCHANGE FUNDS

Exchange funds have been in existence for decades, but came into the limelight in the 1960s.[90] The statutes regulating exchange funds have been revised and reexamined by Congress through the years, but the tacit consent of the investment vehicle has nonetheless survived.[91] In order to understand the current rules and carve-outs, it is important to briefly cover the evolutionary saga of the current Code sections. The trigger that allows exchange funds to operate is the application of the nonrecognition treatment of either Section 351 or 721 of the Code to the contribution of the securities to the fund.[92] There are six main legislative periods that need to be addressed: (i)

85. Albert v. Alex Brown Mgmt. Servs., No. Civ.A. 762-N, Civ.A. 763-N, 2005 WL 2130607, at *5 n.17 (Del. Ch. Aug. 26, 2005) ("'Collaring' is financial jargon for purchasing offsetting calls and puts on a security to limit upside and downside exposure. At the inception of the Funds, the Managers attempted to limit upside and downside exposure to roughly 10%.").

86. *Id.*

87. *Id.* at *5.

88. *Id.* "The Managers then made the decision to remove the collars on the Funds, a decision that had beneficial effects in the short-term . . . ." *Id.*

89. *Id.* at *5-6.

90. *See* Chirelstein, *supra* note 8, at 185; Jackel & Sowell, *supra* note 57, at 1659; Lee A. Sheppard, *Rationalizing the Taxation of Exchange Funds*, 95 TAX NOTES 152 (2002) [hereinafter Sheppard, *Rationalizing*].

91. *See* Jackel & Sowell, *supra* note 57, at 1659 ("The first anti-swap fund legislation was enacted in 1966 to address corporate exchange funds. . . . The swap fund saga continued its evolutionary pace in 1976 when, due to the removal of the non-tax impediments to the use of partnerships, the partnership exchange fund came into vogue. . . . [T]wo decades later, in 1997, . . . the investment company statute was significantly expanded . . . ."); STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL 361 (Comm. Print 2000) ("Congress has been aware of swap funds and has enacted legislation on several occasions to curtail their availability.").

92. *See* BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2; Chirelstein, *supra* note 8, at 184 ("Although the securities exchanged have substantially appreciated in value in the hands of the individual investors, the exchange is claimed to be non-taxable to the investors owing to the presumed applicability of Internal Revenue Code section 351 . . . ."); Sheppard, *Rationalizing*, *supra* note 90, at 152; Sheppard, *Ruby Slippers*, *supra* note 8, at 1699 ("Once again, the section 351(e) and section 721(b) limitations on the tax-free formation of investment companies have proved ineffectual and easily avoidable."); Jerome M. Hesch & Elliot Man-

pre-1966; (ii) the 1966 investment company statute and accompanying regulations; (iii) the 1976 partnership legislation; (iv) the 1980 proposed regulations; (v) the 1996 regulations; and (vi) the 1997 statutory amendment. The first two periods deal with the nonrecognition provisions regarding corporations. The last four periods deal with both corporation and partnership nonrecognition. However, it should be noted that very few, if any, funds are currently structured as corporations.[93] Most funds go out of the way to ensure that they will be treated as partnerships for tax purposes.[94]

A. Pre-1966 Section 351(a)

Section 351(a) of the Code provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation."[95] Prior to 1966, investors would contribute appreciated stock to a company and utilize Section 351 for nonrecognition.[96] In 1960, the Service issued a series of rulings that granted nonrecognition treatment under Section 351.[97] The Service ruled that upon the transfer of appreciated stock to an investment corporation, nonrecognition treatment would be applicable if the transferees were in control of the corporation post transfer.[98]

As discussed above,[99] the application of Section 351 to an arrangement that allows investors to obtain tax-free diversification does not appear to be a clean fit.[100] Section 351 is traditionally applied to a start-up business.[101] It

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ning, *Partnership Investment Company Rules for Family Limited Partnerships*, 22 TAX MGM'T EST. GIFTS & TR. J. 200, 200 (1997).

93. *See* Beldore, *supra* note 18, at 78 ("Were the Fund, the Company or the Portfolio to be treated as a corporation rather than as a partnership for tax purposes, its income would be subject to federal corporate income tax at a current maximum rate of 35%. In addition, distributions to Investors (or Shareholders, in the case of the Fund) would be characterized as dividends or otherwise treated as corporate distributions, and there would be no flow-through of items of income, gain, loss and deduction to Investors or Shareholders.").

94. *See, e.g.*, *id* ("The tax aspects discussed below depend, in large part, on the determination that the Fund, the Company and the Portfolio will be partnerships rather than corporations for federal income tax purposes.").

95. I.R.C. § 351(a) (2006). *See also* Jackel & Sowell, *supra* note 57, at 1660.

96. *See* Chirelstein, *supra* note 8, at 190-91; Jackel & Sowell, *supra* note 57, at 1660.

97. *See, e.g.*, I.R.S. Tech. Info. Release 303 (Feb. 9, 1961); I.R.S. Tech. Info. Release 312 (Mar. 13, 1961); I.R.S. Priv. Ltr. Rul. 6205236350A (May 23, 1962); I.R.S. Priv. Ltr. Rul. 6104106310A (Apr. 10, 1961); I.R.S. Priv. Ltr. Rul. 6103249060A (Mar. 24, 1961). *See also* Jackel & Sowell, *supra* note 57, at 1660; Chirelstein, *supra* note 8, at 186.

98. Jackel & Sowell, *supra* note 57, at 1660.

99. *See supra* Part IV.

100. *See* Chirelstein, *supra* note 8, at 184-85,190.

is generally accepted that the rules in Section 351 are contemplated to apply where a few shareholders would start a business and contribute capital to the business.[102] But by 1961, exchange or swap fund promoters were applying these rules to transactions involving thousands of shareholders who were assembled by a promoter.[103] Moreover, these shareholders were turning over control of the corporation to the promoters and no longer managing the corporation on a day-to-day basis.[104] These promoters were buoyed by the availability of IRS rulings substantiating their tax position and by the ceasing of IRS rulings either for or against the proposition.[105]

In 1961, it had become evident[106] that exchange funds were, in the Service's view, an unintended consequence. Thus, the Service issued a "no rule" position in Revenue Procedure 62-32.[107] The Service was cautious to confine the applicability of its "no rule" position to transactions involving exchanges of securities or shares to newly formed investment companies "as a result of solicitation by promoters, brokers or investment houses."[108] The Service's interpretation of Section 351 appears to have applicability only to corporate formations where there was a prior association.[109]

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101. *See id.* at 190 ("What is undoubtedly conceived of as typical of section 351 is a relatively small-volume transaction involving either the incorporation of an existing business by its owners or the establishment of a new business by a limited number of individuals desiring to combine their capital and skills."); BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.1 (describing Section 351 transaction as formation of a joint venture); BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2 ("Section 351 does not apply to a 'transfer of property to an investment company.'").

102. *See* Chirelstein, *supra* note 8, at 190.

103. *See id.*; Jackel & Sowell, *supra* note 57, at 1660.

104. *See* Chirelstein, *supra* note 8, at 190; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2; *see generally* I.R.S. Tech. Info. Release 303 (Feb. 9, 1961).

105. *See* Chirelstein, *supra* note 8, at 190; Jackel & Sowell, *supra* note 57, at 1660; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2; *see generally* I.R.S. Tech. Info. Release 303 (Feb. 9, 1961).

106. Chirelstein, *supra* note 8, at 191 ("The suspicion [of misapplication of section 351] grows stronger by reason of the circumstantial resemblance between fund formations and what former Commissioner Caplin has called an ordinary 'marketplace exchange of securities.'" (citing Mortimer M. Caplin, *Taxpayer Rulings Policy of the Internal Revenue Service: A Statement of Principles*, 20 INST. ON FED. TAX'N 1, 23 (1962))).

107. Rev. Proc. 62-32, § 3, 1962-2 C.B. 527, 528. *See also* S. REP. NO. 89-1707, *reprinted in* 1966-2 C.B. 1059; Chirelstein, *supra* note 8, at 191; Jackel & Sowell, *supra* note 57, at 1660; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

108. Rev. Proc. 62-32, § 3.14(b), 1962-2 C.B. 527, 530. *See also* S. REP. NO. 89-1707, *reprinted in* 1966-2 C.B. 1059; Chirelstein, *supra* note 8, at 191.

109. Interestingly, the Service did not attack exchange funds directly on the "control" issue. Section 351(a) requires the transferees to be in "control" of eighty percent of the outstanding shares of the corporation after the transfer. I.R.C. § 351(a) (2006). In an exchange fund, although the shareholders held more than eighty percent of the equity, they did not in the pre-1962 form of entity have control over the entity. They were more akin to a passive investor. Yet, the Service never argued substance over form and attacked the pre-arranged transaction. "In effect, the argument would be that the fund, having been formed initially by

On July 14, 1966, proposed regulations were recommended.[110] These regulations provided that the exchange fund transaction would not qualify for nonrecognition treatment.[111] Before the Regulations could be passed, in November of 1966, Congress enacted legislation, commonly referred to as the Foreign Investor's Tax Act of 1966, subjecting exchange funds to taxation.[112]

B. Foreign Investor's Act of 1966 and 1967 Regulations

The term "investment company" came into tax vernacular in the Foreign Investor's Tax Act of 1966.[113] At the time, this was considered a minor "Christmas tree" tax bill.[114] The legislation was directed at the nonrecognition provision of Section 351.[115] Targeted transactions were those that resulted in diversification of securities in a tax-free manner using Section 351.[116] Congress "limited nonrecognition treatment under section 351 to contributions to corporations other than [what are referred to as] 'investment companies.'"[117] Given the action and discussions leading up to the legislation, it was surprising that the legislation was silent regarding the operation of the new Section 351.[118] In 1967, the Treasury promulgated

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issuance of a few shares to the promoter or fund management organization, thereafter simply distributed its stock to the public in a series of disconnected transactions which are not entitled to be viewed in the aggregate." Chirelstein, *supra* note 8, at 192. The aforementioned series of transactions would then cause the subsequent shareholders to have exchanged their interests for a noncontrolling interest in the entity and thus create a taxable exchange.

110. S. REP. NO. 89-1707, at 61 (1966), *as reprinted in* 1966-2 C.B. 1102; Jackel & Sowell, *supra* note 57, at 1660.

111. S. REP. NO. 89-1707, at 61 (1966), *as reprinted in* 1966-2 C.B. 1102. *See also* Jackel & Sowell, *supra* note 57, at 1660.

112. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 203(c), 80 Stat. 1539, 1577 (1966) ("The amendments made by subsections (a) and (b) [amending this section] shall apply with respect to transfers of property to investment companies whether made before, on, or after the date of the enactment of this Act [Nov. 13, 1966].").

113. *See id*. § 203(b).

114. *A Stop to the Swap?*, TIME, Feb. 10, 1967, *available at* http://www.time.com/time/magazine/article/0,9171,840854,00.html [hereinafter *Stop to the Swap*].

115. *See, e.g.*, T.D. 6942, 1968-1 C.B. 136.

116. Foreign Investors Tax Act § 203. *See also* S. REP. NO. 1707 (1966), *reprinted in* 1622-2 C.B. 1059.

117. Jackel & Sowell, *supra* note 57, at 1660. *See also* Foreign Investors Tax Act §203; *Stop to the Swap*, *supra* note 114.

118. *Stop to the Swap*, *supra* note 114 ("Even in the vast and fast-growing mutual-fund business, the swaps have had a remarkable rise. The first was organized less than seven years ago by Denver Banker William M.B. Berger, 41, who had the bright—and right—idea that Section 351 (a), which had been drawn to allow the tax-free transfers of property to a new corporation in exchange for stock, could also apply to individual stockholders.").

regulations that not only expanded the reach of the legislation, but actually limited it as well.[119]

The term "investment company" was defined in the 1967 regulations broadly.[120] The term "investment company" included[121]: (1) a regulated investment company (RIC);[122] (2) a real estate investment trust (REIT);[123] or (3) a corporation where the assets (excluding cash and nonconvertible debt obligations) were more than eighty percent of the value of the company.[124] The assets defined in the regulations at that time were "readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts."[125] This became known as the "80% test." For the purpose of this threshold test, stock and securities in subsidiary corporations were disregarded.[126] The parent corporation was deemed to own a ratable share of the subsidiary corporation.[127]

Since there was no prior guidance, the Regulations had to define the most basic elements of the new term "investment company." For example, when was the 80% test to apply? Immediately after transfer? "The regulations provided that the determination of whether a corporation was an investment company . . . should be made . . . immediately after the transfer in question."[128] Nonetheless, if there was a change following the contribution, which was "pursuant to a plan," then the determination of investment company status was made on the date the plan was completed.[129]

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119. *See* Rev. Rul. 67-122, 1967-1 C.B. 78.

120. Treas. Reg. § 1.351-1(c)(1)(ii) (1968).

121. *See id.*

122. *See id. See also* I.R.C. § 851 (2006). In sum, RIC must derive at least ninety percent of its income from dividends, interest, and capital gains. *Id.*

123. Treas. Reg. § 1.351-1(c)(1)(ii). *See also* I.R.C. § 856 (2006). Generally, a REIT owns income producing real estate and distributes ninety percent of taxable income each year to shareholders as dividends. *Id.*

124. Treas. Reg. § 1.351-1(c)(1)(ii).

125. *Id*. *See also* Jackel & Sowell, *supra* note 57, at 1661; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

126. Treas. Reg. § 1.351-1(c)(4). *See also* Jackel & Sowell, *supra* note 57, at 1661; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

127. Treas. Reg. § 1.351-1(c)(4). *See also* Jackel & Sowell, *supra* note 57, at 1661 (finding that for the purposes of the regulations, a "subsidiary" corporation is one where "the parent owned 50 percent or more of (1) the combined voting power of all classes of stock entitled to vote, or (2) the total value of shares of all classes of stock outstanding").

128. Jackel & Sowell, *supra* note 57, at 1661; Treas. Reg. § 1.351-1(c)(2) (2009). *See also* BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

129. Treas. Reg. § 1.351-1(c)(2) (2009). *See also* Jackel & Sowell, *supra* note 57, at 1661; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2; Sheppard, *Rationalizing*, *supra* note 90, at 152 ("It would be nice if all these inquiries about what is being contributed to the corporation or partnership were objective, but they are not. Regulation section 1.351-1(c) asks a lot of questions about the parties' intentions for the contributed assets.").

The test for the purposes of the Regulation was whether diversification was achieved after the transfer.[130] So, to some extent, the statute was limited to only situations in which diversification[131] took place.[132] Further, if there was diversification, but only to a *de minimis* amount, this was disregarded for investment company purposes.[133] The regulations included a step-transaction type analysis to determine if there was diversification for the *de minimis* rule.[134]

C. 1976 Legislation Addressing Partnership—New Section 721

By 1976, the investment world had changed.[135] In 1966, exchange funds could only operate through a corporate form. There were various state partnership problems and a myriad of securities restrictions that prohibited the use of the partnership form. Therefore, when the Foreign Investor's Tax Act was passed, it only made changes to Section 351 regarding corporations.[136]

However, as partnership rules changed in the early 1970s, exchange funds were being established in the partnership form.[137] Almost a blow-by-blow reoccurrence of the 1960 events happened with partnerships. First, in 1975, the Service issued a private ruling allowing investors to transfer the same type of appreciated securities to a partnership without recognizing current tax.[138] In effect, the Service ruled that because there was no similar

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130. *See* BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

131. For the purposes of the Regulations, diversification is the transfer, by two or more people, of nonidentical assets. Treas. Reg. § 1.351-1(c)(5). *See also* Jackel & Sowell, *supra* note 57, at 1661; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

132. Treas. Reg. § 1.351-1(c)(1)(i). *See also* Jackel & Sowell, *supra* note 57, at 1661; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

133. The example provided in the Regulations is that an amount of less than one percent (1%) of the total value of assets transferred would be "insignificant." Treas. Reg. § 1.351-1(c)(5)-(7). *See also* Jackel & Sowell, *supra* note 57, at 1661-62; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

134. Treas. Reg. § 1.351-1(c)(5). *See also* Jackel & Sowell, *supra* note 57, at 1662; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

135. *See generally* STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 655-56 (Comm. Print 1976) [hereinafter GENERAL EXPLANATION]; S. REP. NO. 94-938, at 1 (1976); Hesch & Manning, *supra* note 92; Jackel & Sowell, *supra* note 57, at 1662.

136. GENERAL EXPLANATION, *supra* note 135. As for treatment of partnerships pre-1954 subchapter K, taxpayers had to rely on administrative and case law precedents. *See* Helvering v. Walbridge, 70 F.2d 683, 684-85 (2d Cir. 1934).

137. GENERAL EXPLANATION, *supra* note 135, at 656 ("Recently, however, these difficulties were resolved and a number of public syndications were organized to sell exchange funds as partnerships.").

138. I.R.S. Priv. Ltr. Rul. 7504280550A (Apr. 28, 1975). The Vance, Sanders Exchange Fund was granted tax-free status. *See also* GENERAL EXPLANATION, *supra* note 135, at 656; S. REP. NO. 94-938.

prohibition to 351 in the partnership rules, this transfer was permissible, thereby opening the floodgates for pre-1966 diversification using the partnership form.[139]

The ability to use the partnership form was more than merely a change of form to avoid the investment company rules under Section 351 for corporations. As a partnership, the exchange fund did not incur taxes at the entity level.[140] Items of partnership income, gain, loss, and deductions flowed through to the investors. Conversely, if the exchange fund was treated as a corporation, it was subjected to the corporate income tax at current levels.[141] Additionally, distributions were characterized as dividends or otherwise treated as corporate distributions.[142] Thus, there was no flow-through of income, gain, loss, and deductions to the investors.

Congress concluded that the mere shift in form from corporate to partnership should not change the results.[143] The diversification of assets, whether through contributions to a partnership or corporation, should not have tax-free treatment.[144] Unlike in 1966, Congress attacked the partnership version of exchange funds more squarely on the control issue. "Congress noted that, in the typical situation, even after joining an exchange fund, the investors generally did not want the managers to sell off either their own or other stocks . . . ."[145] Congress differentiated between traditional partnerships where owners pooled assets and know-how in order to share risks in an ongoing business, and an exchange fund where partners were not sharing risk, assets, or know-how, but were merely using an investment vehicle jointly.[146]

Based on this approach during the debates in Committee, it was foreseeable that Congress would enact a corresponding code section to 351 for partnerships.[147] Congress thus enacted Section 721(b), which provided that the nonrecognition provisions of Section 721(a) of the Code no longer applied "to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section

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139. I.R.S. Priv. Ltr. Rul. 7504280550A (Apr. 28, 1975).

140. *See* Jackel & Sowell, *supra* note 57, at 1662.

141. *See* Chirelstein, *supra* note 8, at 188-89; Jackel & Sowell, *supra* note 57, at 1663; Beldore, *supra* note 18, at 78.

142. *See* Chirelstein, *supra* note 8, at 189; Jackel & Sowell, *supra* note 57, at 1663.

143. *See* GENERAL EXPLANATION, *supra* note 135, at 656; S. REP. NO. 94-938; Jackel & Sowell, *supra* note 57, at 1663. *See supra* note 134 and accompanying text.

144. S. REP. NO. 94-938; Jackel & Sowell, *supra* note 57, at 1663. *See supra* note 134 and accompanying text.

145. Jackel & Sowell, *supra* note 57, at 1662. *See also* GENERAL EXPLANATION, *supra* note 135, at 656; S. REP. NO. 94-938, pt. 11.

146. *See* Jackel & Sowell, *supra* note 57, at 1662. *See also* GENERAL EXPLANATION, *supra* note 135, at 656; S. REP. NO. 94-938, pt. 11.

147. The 1976 legislation also enacted Section 683, which applied the investment company rules to trusts.

351) if the partnership were incorporated."[148] Moreover, once a partnership was classified as an investment company, the entity was prohibited from electing out of partnership tax classification under Section 761(a).[149]

In the legislation, Congress also attacked corporate reorganizations that resulted in diversification. Congress closed the loophole left after Section 351 by enacting Section 368(a)(2)(F). This prevented taxpayers from diversifying the appreciated securities through contribution to a wholly owned corporation and later merging that corporation with other corporations.[150] There were significant differences between Sections 368(a)(2)(F) and 351 involving the calculation of the 80% test.[151] At its heart, Section 368 exempted reorganization transfers for entities that already held diversified portfolios.[152]

D. 1980 Proposed Regulations

Changes to the Regulations under Section 368(a)(2)(F)[153] of the Code and an amendment to regulations under Section 1.351-1(c) were proposed by the Service. The proposed regulations were designed to deal with transfers to pre-existing entities. For example, assume that there are two companies which hold one asset that is a single stock position. If one company transferred 80% of the voting stock in exchange for 100% of the voting stock of the other company, would it qualify under Section 351? Under the proposed regulations, this would not qualify.[154] The distinction in the proposed regulations would be that the *de minimis* rule would no longer apply. These proposed regulations were not finalized and were actually revoked in 1998.[155]

E. 1996 Regulations

In 1976, when Congress promulgated Section 721 of the Code for partnerships and Section 368 for reorganizations, a broader definition of diversification was utilized.[156] Under the Regulations for Section 351 in

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148. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 721, 90 Stat. 1520 (1976).

149. *See* GENERAL EXPLANATION, *supra* note 135, at 658 n.6; Jackel & Sowell, *supra* note 57, at 1662.

150. *See* Jackel & Sowell, *supra* note 57, at 1662.

151. *Id.* at n.16.

152. *See id.* at 1663.

153. Investment Companies, 46 Fed. Reg. 1744, 1747-48 (proposed Jan. 7, 1981). *See also* Jackel & Sowell, *supra* note 57, at 1663.

154. Investment Companies, 46 Fed. Reg. 1744, 1746 (proposed Jan. 7, 1981). *See also* Jackel & Sowell, *supra* note 57, at 1663.

155. *See* Jackel & Sowell, *supra* note 57, at 1664; Withdrawal of Proposed Regulations, 63 Fed. Reg. 71047 (proposed Dec. 23, 1998).

156. *See supra* Section IV.C.

1967, a more stringent rule existed that resulted in diversification unless there was a *de minimis* transfer.[157] In the early 1990s, the Service started to issue private letter rulings providing a case-by-case determination of whether diversification had occurred.[158] Because the Service was no longer following the fixed approach under the earlier regulations, the area of *de minimis* transactions became subjective.[159]

In 1996, the regulations were amended to provide for an objective standard.[160] The regulations provided that a contribution of diversified securities to an entity would not result in diversification.[161] As any estate planning attorney could attest, if one contributes a diversified portfolio and receives back a proportionate share in the company, there is no diversification.[162] The test for diversification is the same as in Section 368(a)(2)(F).[163] There is no diversification and thus nonrecognition "if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of 5 or fewer issuers."[164]

F. Amendment of 351(e) in the Taxpayer Relief Act of 1997

As is often the problem with reactionary legislation, the Service and Congress acted before they had a full understanding of the complex financial instruments they were attacking. The Service thought that exchange funds had gone by the wayside, even though that was not true.[165] Therefore, in 1997, Congress added Section 351(e) to expand the categories of assets

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157. *See* Jackel & Sowell, *supra* note 57, at 1661.

158. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 9519003 (Jan. 31, 1995); I.R.S. Priv. Ltr. Rul. 9518005 (Jan. 31, 1995); I.R.S. Priv. Ltr. Rul. 9509010 (Nov. 30, 1994); I.R.S. Priv. Ltr. Rul. 9451035 (Sept. 20, 1994); I.R.S. Priv. Ltr. Rul. 9421014 (Feb. 23, 1994); I.R.S. Priv. Ltr. Rul. 9351031 (Sept. 28, 1993).

159. *See* Sheppard, *Ruby Slippers*, *supra* note 8, at 1700-01; Jackel & Sowell, *supra* note 57, at 1663-64; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

160. Transfers to Investment Companies, 60 Fed. Reg. 40794, 40794-96 (proposed Aug. 10, 1995). *See also* Jackel & Sowell, *supra* note 57, at 1664.

161. Treas. Reg. § 1.351-1(c)(6)(i) (1999). *See also* Jackel & Sowell, *supra* note 57, at 1664.

162. *See* Hesch & Manning, *supra* note 92, at 204 ("Essentially, diversification occurs if other family members (or any other investors) transfer different assets to the same partnership. If two or more transferors contribute identical assets to a newly organized partnership, the pooling does not result in diversification."). Often in estate planning contexts, husband and wife would contribute the different securities to a joint account first, then transfer their respective interests to the newly formed family partnership.

163. *See* Jackel & Sowell, *supra* note 57, at 1663-64.

164. I.R.C. § 368(a)(2)(F)(ii) (2006). *See also* Jackel & Sowell, *supra* note 57, at 1663.

165. For example, Beldore closed in October, 2008. Beldore, *supra* note 18.

included in the definition of "investment company."[166] This was Congress's attempt to stop the newest evolution of exchange funds.[167]

The new Section 351(e) greatly expanded which assets would determine whether an entity, other than a RIC or REIT, would be classified as an investment company.[168] Prior to 1997, the 80% test was limited to readily marketable securities, stocks, or interests in RICs or REITs.[169] The newly expanded Act stated if more than 80% of the assets were:

> money; stocks [or] other equity interests in a corporation; evidences of indebtedness, options, forward or future contracts, notional principal contracts or derivatives; foreign currency; some interests in precious metals; interests in REITs, RICs, common trust funds, and publicly traded partnerships; or other interests in noncorporate entities that are convertible into, or exchangeable for, any of the assets listed,[170]

then the contribution would be subject to taxation.[171] The question remains: why did Congress try to legislate away a loophole that easily could have been closed by prohibiting the diversification in total?[172]

Upon the review of the legislative history, Congress merely limited the types of assets that could be used for the 80% test. Congress did not override the existing regulations.[173]

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166. Jackel & Sowell, *supra* note 57, at 1664; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1002(a), 111 Stat. 788, 909 (1997); STAFF OF THE JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 183 (Comm. Print 1997) [hereinafter 1997 LEGISLATION EXPLANATION] ("Of particular concern to the Congress was the reappearance of so-called 'swap funds,' which are partnerships or RICs that are structured to fall outside the definition of an investment company, and thereby allow contributors to make tax-free contributions of stock and securities in exchange for an interest in an entity that holds similar assets.").

167. Jackel & Sowell, *supra* note 57, at 1664; Taxpayer Relief Act of 1997 § 1002(a); 1997 LEGISLATION EXPLANATION, *supra* note 166, at 183.

168. STAFF OF THE JOINT COMM. ON TAXATION, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL 361-62 (Comm. Print. 2000); Jackel & Sowell, *supra* note 57, at 1664-65.

169. Jackel & Sowell, *supra* note 57, at 1664.

170. Jackel & Sowell, *supra* note 57, at 1664-65.

171. I.R.C. § 1:731-2(c)(3)(i) (1996); Jackel & Sowell, *supra* note 57, at 1664-65.

172. *See, e.g.*, Sheppard, *Ruby Slippers*, *supra* note 8, at 1701.

173. *See* Jackel & Sowell, *supra* note 57, at 1665 ("Specifically, the legislative history states that the new statute does not override: (1) the requirement that only assets held for investment are considered for purposes of the definition; (2) the rule treating the assets of a subsidiary as owned proportionally by a parent owning 50 percent or more of its stock; (3) the requirement that a contribution of property to an investment company must result in diversification for gain to be recognized; and (4) the requirement that the investment company determination must consider any plan concerning an entity's assets in existence at the time of the transfer.").

V. TAX ANALYSIS

Since the first reported exchange fund in 1960,[174] Congress and the Service have been, through piecemeal legislation, attacking and narrowing the rules for these entities. They have created a minefield of burdensome rules without directly attacking the root problem. However, these rules are only an issue for the ill-advised.[175] With a well thought out plan, these rules are easy to avoid.[176] However, if a company fails the investment company tests, the penalty is high—gain recognition for all investors.[177] Thus, one would expect to have a black-and-white result for contributions. Clarity on how to navigate the rules in Sections 351 and 721 of the Code does not exist. The following highlights some of the shortfalls of the current system.

A. Financial Instruments and the 80-20 Rule

As discussed earlier, Section 721(b) provides the general rule that gain is recognized where a transfer of appreciated stocks, securities, or other property is made to a partnership that would be treated as an investment company under Section 351 were the partnership a corporation.[178] The determination whether a partnership will be treated as an investment company is made under Section 351(e)(1).[179]

Since the purpose of Section 351 is being abused by exchange fund promoters, congressional reactionary legislation continues to miss all the different financial instruments that can be used in place of prohibited assets. Given the patchwork approach Congress and the Service have taken to decide which items are and are not securities, it is no surprise that the promoters of exchange funds can either create or find financial instruments that are not addressed by the statute.

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174. *Stop to the Swap*, *supra* note 114.

175. For example, the estate planner who triggered gain on the contribution of assets to a family limited partnership. Hesch & Manning, *supra* note 92, at 200-01. *See also* Sheppard, *Rationalizing*, *supra* note 90, at 152.

176. After all, that is the reason we have the rules. As sophisticated tax professionals are given rules, they immediately think of how to avoid the rules. *See generally* Sheppard, *Rationalizing*, *supra* note 90, at 152; Sheppard, *Ruby Slippers*, *supra* note 8, at 1700-01; Jackel & Sowell, *supra* note 57, at 1667.

177. *See* Jackel & Sowell, *supra* note 57, at 1667.

178. I.R.C. § 721(b) (1997). *See generally* BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2; Beldore, *supra* note 18, at 79.

179. A partnership will be treated as an investment company if, after the exchange, over eighty percent of the value of its assets are held for investment and are "stock and securities" (or interests in real estate investment trusts or in regulated investment companies). Property covered by this gain recognition rule isn't limited to stock and securities but includes eight categories of assets. *See* Hesch & Manning, *supra* note 92, at 201; Beldore, *supra* note 18, at 79.

At the heart of the matter, financial instruments are merely contracts. There are two counterparties agreeing to terms. Since the instruments are largely unregulated, they are easily manipulated. The most basic example of manipulation of instruments is if the government was to prohibit the use of a put option. However, a put option actually has two components: a knock-in and knock-out option.[180] So, if an investor bought a knock-in and knock-out option, he or she is not violating the put option rules.[181] Further, these instruments are merely contracts between a buyer and a seller.[182] They are not regulated, and the other side of the contract (other than through traditional contractual remedies) might not be able to fulfill his or her obligation at close.[183]

In the realm of exchange funds, there are often a lot of games played using "security-like" assets. It is in the interest of the fund's promoter to locate assets that provide stable returns with some level of liquidity but that are not classified as "securities" for the purposes of Section 351.[184] Most often, fund promoters work around the term "evidences of indebtedness."[185]

Under Treasury Regulation Section 1.1275-1(d), the term "debt instrument" is "any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan)."[186] So, for the purposes of the aforementioned regulation, a "debt instrument" is an "evidence of indebtedness."[187]

Even with all the congressional and governmental actions, there is no direct authority if "the term 'evidence of indebtedness' is limited to traditional debt instruments."[188] How would the Service consider a cash flow

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180. *See generally* Peter Carr & Andrew Chou, Hedging Complex Barrier Options (New York University Working Paper 2002), *available at* http//www.math.nyu.edu/ research/carrp/papers/pdf/multipl3.pdf; JON C. COX & MARK RUBINSTEIN, OPTIONS MARKETS (1985); George L. Ye, *Exotic Options: Boundary Analyses*, 15 J. DERIVATIVES & HEDGE FUNDS 149-57 (2009).

181. Carr & Chou, *supra* note 180; COX & RUBINSTEIN, *supra* note 180; and Ye, *supra* note 180.

182. Carr & Chou, *supra* note 180; COX & RUBINSTEIN, *supra* note 180; and Ye, *supra* note 180.

183. Carr & Chou, *supra* note 180; COX & RUBINSTEIN, *supra* note 180; and Ye, *supra* note 180.

184. *See* Jackel & Sowell, *supra* note 57, at 1672; Sheppard, *Rationalizing*, *supra* note 90, at 152-53.

185. *See* Jackel & Sowell, *supra* note 57, at 1669 ("'Evidences of Indebtedness' is not the only ambiguous phrase contained in the description of listed assets."); BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.1.

186. Treas. Reg. § 1.1275-1(d) (1994).

187. *See* Jackel & Sowell, *supra* note 57, at 1669; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.3.

188. Jackel & Sowell, *supra* note 57, at 1669. *See also* BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.4.

stream of rental real estate?[189] What about viatical settlement contracts? The ambiguity harkens back to one of the fundamental problems related to exchange funds: investment company treatment. If one is incorrect in his or her determination that an asset class qualifies, then the result will be investment company status.[190] This will create a current tax for contributors.

Most importantly, the traditional assets used in the exchange fund structure to satisfy the 80% test are interests in umbrella real estate investment trusts (UPREITs).[191] Congress classified REITs as "securities" for the purposes of satisfying the 80% test in the investment company rules.[192] As a result, the promoters turned to the REITs' close cousin: the UPREIT. A UPREIT is essentially a REIT with a lock-up.[193] More specifically, UPREIT units are exchangeable, after a fixed period, into stock of the underlying REIT at the election of the UPREIT holder.[194]

It could be effectively argued that the UPREIT units do not pass the "evidence of indebtedness" test as they appear to be "readily convertible" into either stock of the REIT or money.[195] On one hand, the exchange fund would argue that, given the lock-up, the units are not readily convertible until after the fixed period.[196] The problem that arises is two-fold. First, there is no definition of "readily convertible."[197] Second, Congress and the Service are unable to comprehend the difficulty in legislating against financial instruments. These contracts can be manipulated with specific carveouts to meet any rule.

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189. Jackel & Sowell, *supra* note 57, at 1669.

190. *See* Jackel & Sowell, *supra* note 57, at 1669; Sheppard, *Rationalizing*, *supra* note 90, at 152. *See also* Beldore *supra* note 18, at 3-5.

191. *See* Beldore, *supra* note 18, at 3-5; Jackel & Sowell, *supra* note 57, at 1669.

192. I.R.C. § 351 (2000).

193. *See* Jackel & Sowell, *supra* note 57, at 1669; Treas. Reg. § 1.701-2(d), Example 4; Beldore, *supra* note 18, at 3-5.

194. Jackel & Sowell, *supra* note 57, at 1669. Sometimes the conversion is into actual cash at the option of the REIT. This would be even better for the exchange fund manager as after seven years, they can convert readily to cash positions for the unwinding of the entity. *See id.*

195. *Id.*

196. *Id.*

197. *See id.* (noting that there are "similar rules in the installment sale regulations under section 453." In Treas. Reg. § 15a.453-1(e)(5), an obligation is readily tradable if the obligation may be converted to a tradable security without a substantial discount. "For this purpose, a 'substantial discount' exists if the obligation, when issued, is convertible for less than 80 percent of its current value." Generally, UPREITs are convertible at a one-to-one basis, and they have equivalent fair market values; thus UPREITs would seem to meet the aforementioned standard).

B. Timing of Investment Company Status

"Treasury Regulation Section 1.351-1(c)(2) provides that the determination of whether a corporation is an investment company will ordinarily be made . . . immediately after the transfer."[198] However, when the investment blends or "circumstances change pursuant to a plan in existence at the time of transfer, the determination" will be made after the plan is in place.[199] Most funds have a requirement in the agreement that will ensure that more than 20% of the assets will be invested in Qualifying Assets.[200]

There is no true guidance on determining what is or is not a plan in the context of Sections 351 and 721.[201] In at least two other Code sections, there is guidance as to what constitutes a "plan."[202] More importantly, the Service often uses the term "plan" in arguing for application of the "step transaction doctrine."[203] When taxpayers attempt to skirt the technical application of the rules through a literal interpretation, the Service takes the position that the series of steps will be integrated into one transaction.[204]

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198. Beldore, *supra* note 18, at 80. *See also* Jackel & Sowell, *supra* note 57, at 1665.

199. Beldore, *supra* note 18, at 80. *See also* Jackel & Sowell, *supra* note 57, at 1665, 1666-67; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2.

200. *See* Beldore, *supra* note 18, at 3 ("Separate from its investment in the Portfolio through the Company, the Fund will also invest in certain assets that must constitute at least 20% of the Fund's assets in order for the exchange of contributed securities for the Shares of the Fund to be non-taxable."); Sheppard, *Ruby Slippers*, *supra* note 8, at 1700 ("Greene Street promises that at least 21 percent of the master partnership's portfolio will consist of things that are not covered by section 351(e)(1)(B) . . . .").

201. *See* I.R.S Priv. Ltr. Rul. 9013016 (Mar. 30, 1990) (responding to an inquiry where the partners contributed timber cutting rights, timber and timber land, and marketable securities to a partnership). Partners had no plan to dispose of the timber and timber land for the next two years and no more than $500,000 of the timber would be sold within the next five years. Service ruled that this was not an investment company. *Id.* *See also* Jackel & Sowell, *supra* note 57, at 1666; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2; Sheppard, *Ruby Slippers*, *supra* note 8, at 1699-1701.

202. See proposed regulations under Section 355(e) of the Code, which defines the phrase "plan (or series of related transactions)" broadly. Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. 66, 67 (Jan. 2, 2001). While the regulations under Section 355(d) of the Code narrowly define "plan," a "plan or arrangement" only exists if there are formal understandings. Treas. Reg. § 1.355-6(c)(4) (2008). *See* Jackel & Sowell, *supra* note 57, at 1666 n.51.

203. *See* Jackel & Sowell, *supra* note 57, at 1666.

204. The main step transaction theories are "binding commitment," "mutual interdependence," or "end result." *See* Comm'r v. Gordon, 391 U.S. 83, 96 (1968) ("[I]f one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps."); Am. Bantam Car Co. v. Comm'r, 11 T.C. 397, 405 (1948), *aff'd* 177 F.2d 513 (3d Cir. 1949) (stating that factors to consider include the mutual interdependence and temporal proximity of the acts); Kanawha Gas & Utils. Co. v. Comm'r, 214 F.2d. 685, 691 (5th Cir. 1954) (finding that the end result is a "series of transactions designed and executed as parts of a unitary plan to achieve an intended result"). *See also* Jackel & Sowell, *supra* note 57, at 1666.

Arguably, the overall requirement that the fund maintain a qualifying ratio of investments might be sufficient to meet the plan tests.[205]

Regardless of how the Service would interpret the term "plan," the question is whether this is a static determination.[206] Is the determination made upon formation? Is it made after the plan is to be completed? Is it to be made each year? It has been effectively argued by some that a better reading of the regulations is that taxpayers should analyze investment company status immediately after a contribution.[207] In the case of an asset mix which changes over time "pursuant to a plan" (which exists upon contribution), any changes caused by the plan should relate back to the date of contribution.[208] Therefore, even though at times the entity is out of compliance, this is not fatal and can be cured.

C. Tax Avoidance

So what happens when tax practitioners apply certain sections to unintended and unexpected situations? Generally, the Service goes on the offensive and attacks the problem. For example, when tax practitioners were using Sections 358 or 752[209] to shelter billions of dollars[210] the Service acted

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205. *See* Beldore, *supra* note 18, at 3 ("[T]he Fund will also invest in certain assets that *must* constitute at least 20% of the Fund's assets in order for the exchange of contributed securities for Shares of the Fund to be non-taxable.").

206. Jackel & Sowell, *supra* note 57, at 1666.

207. *See* Jackel & Sowell, *supra* note 57, at 1667. *See also* Sheppard, *Ruby Slippers*, *supra* note 8, at 1701; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2; Treas. Reg. § 1.351-1(c)(5) (2008).

208. *See* Jackel & Sowell, *supra* note 57, at 1667. *See also* Sheppard, *Ruby Slippers*, *supra* note 8, at 1701; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2; Treas. Reg. § 1.351-1(c)(5) (2008).

209. *See* I.R.S. Notice 2000-44, 2000-36 I.R.B. 255 (2000) ("The purported losses from these transactions (and from any similar arrangements designed to produce noneconomic tax losses by artificially overstating basis in partnership interests) are not allowable as deductions for federal income tax purposes. The purported tax benefits from these transactions may also be subject to disallowance under other provisions of the Code and regulations. In particular, the transactions may be subject to challenge under § 752, or under § 1.701-2 or other anti-abuse rules.").

210. I.R.S. News Release IR-2005-37 (Mar. 24, 2005):

> These arrangements purport to give taxpayers artificially high basis in partnership interests and thereby give rise to deductible losses on disposition of those partnership interests.
>
> One variation involves a taxpayer's borrowing at a premium and a partnership's subsequent assumption of that indebtedness. As an example of this variation, a taxpayer may receive $3,000X in cash from a lender under a loan agreement that provides for an inflated stated rate of interest and a stated principal amount of only $2,000X. The taxpayer contributes the $3,000X to a partnership, and the partnership assumes the indebtedness. The partnership thereafter engages in investment activities. At a later time, the taxpayer sells the partnership interest.

quickly and decisively to stop the abuse. With the state of the economy, the need for additional revenues and the general policy of consistent application of the rules, the tax avoidance structure of swap or exchange funds needs to be addressed. The issue has not been addressed in Congress since 1999 when Representative Neal introduced a bill to amend Section 351.[211] As a country, we are facing tough decisions, and to exempt from examination a loophole for only the wealthy would be an injustice. In fact, the lead paragraph from a *Forbes Magazine* article in 2001 was: "The trouble with loo-

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Under the position advanced by the promoters of this arrangement, the taxpayer claims that only the stated principal amount of the indebtedness, $2,000X in this example, is considered a liability assumed by the partnership that is treated as a distribution of money to the taxpayer that reduces the basis of the taxpayer's partnership interest under § 752 of the Internal Revenue Code. Therefore, disregarding any additional amounts the taxpayer may contribute to the partnership, transaction costs, and any income realized or expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the excess of the cash contributed over the stated principal amount of the indebtedness, even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. In this example, the taxpayer purports to have a basis in the partnership interest of $1,000X (the excess of the cash contributed ($3,000X) over the stated principal amount of the indebtedness ($2,000X)). On disposition of the partnership interest, the taxpayer claims a tax loss with respect to that basis amount, even though the taxpayer has incurred no corresponding economic loss.

In another variation, a taxpayer purchases and writes options and purports to create substantial positive basis in a partnership interest by transferring those option positions to a partnership. For example, a taxpayer might purchase call options for a cost of $1,000X and simultaneously write offsetting call options, with a slightly higher strike price but the same expiration date, for a premium of slightly less than $1,000X. Those option positions are then transferred to a partnership which, using additional amounts contributed to the partnership, may engage in investment activities.

Under the position advanced by the promoters of this arrangement, the taxpayer claims that the basis in the taxpayer's partnership interest is increased by the cost of the purchased call options but is not reduced under § 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the written call options. Therefore, disregarding additional amounts contributed to the partnership, transaction costs, and any income realized and expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the cost of the purchased call options ($1,000X in this example), even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. On the disposition of the partnership interest, the taxpayer claims a tax loss ($1,000X in this example), even though the taxpayer has incurred no corresponding economic loss.

The Internal Revenue Service announced today that taxpayers participating in the Son of Boss tax shelter settlement have so far paid in more than $3.2 billion, a figure that should top $3.5 billion when the project concludes in coming months.

Id.

211. H.R. 2705, 106th Cong. (1st Sess. 1999).

pholes is that the better they are, the better the chance they'll be closed. For years now, lawmakers have been trying to do away with exchange funds, also known as 'swap funds,' which allow holders of highly appreciated stock to diversify without paying capital gains taxes."[212] Yet, here we are in 2009 with the "loophole" in full force.

Moreover, it appears that the approach advocated by Representative Neal equates swap or exchange funds with other types of hedging transactions taxpayers can enter into without current taxation.[213] For example, a taxpayer with a single stock position in Exxon can execute a "costless collar" on the stock by buying a put and a call on the security.[214] Costless collars can be established to fully protect existing long stock positions with little or no cost since the premium paid for the protective puts is offset by the premiums received for writing the covered calls.[215] Depending on the volatility of the underlying stock, the call strike can range from 30% to 70% out of money, enabling the writer of the call to still enjoy a limited profit should the stock price rise.[216] The second step to the "collar" strategy is then to borrow against the fixed position.[217] The end result of the "collar" strategy is similar to an exchange fund: an investor would have cash in order to diversify his or her position.

However, the fundamental difference between the two strategies is the limitation placed on the time horizon of a derivative option compared to the exchange fund. The future horizon of a covered call position is generally five years. Therefore, at the end of the five-year period, if the underlying security significantly decreased or increased in price and did not stay within its range of the collar, the cost of replacing the collar becomes prohibitive.

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212. Boss, *supra* note 14.

213. *See* Sheppard, *Ruby Slippers*, *supra* note 8, at 1701.

214. A "costless collar" is the purchase of a put on the stock exercisable in the future with the simultaneous writing of an out-of-the money covered call option with a strike price which is equal to the premium of the put option. *See generally* Beldore, *supra* note 18, at 41-42; Barnet Phillips, IV, *Exchange Funds: What Is Diversification?*, 838 PLI/TAX 583, 611 (2007); Erika W. Nijenhuis, William L. McRae & Elena V. Romanova, *Everything I Know About New Financial Products I Learned From DECS*, 850 PLI/TAX 129, 179 (2008); Lawrence D. Cavanagh, *Hedging Your Stock With Collars*, VALUE LINE OPTIONS, http://www.valueline.com/edu_options/rep13.html (last visited Oct. 15, 2009); The Options Guide, Costless Collar (Zero-Cost Collar), http://www.theoptionsguide.com/costless-collar.aspx (last visited Oct. 15, 2009).

215. *See generally* Beldore, *supra* note 18, at 41-42; Cavanagh, *supra* note 214; Wilmington Trust, *Costless Collars: Protecting the Value of Your Securities*, http://www.wilmingtontrust.com/wtcom/index.jsp?fileid=3000206 (last visited Oct. 15, 2009).

216. *See generally* Beldore, *supra* note 18, at 41-42; Cavanagh, *supra* note 214; Wilmington Trust, *supra* note 215.

217. *See* Beldore, *supra* note 18, at 41-42; Wilmington Trust, *supra* note 215 ("[I]n this case, the lender might be able to lend up to 80% to 90% of the put strike price.").

For example, assume that Exxon was at $25 a share when the collars were placed on the stock. The collars lasted five years. At the end of the five-year period, if Exxon was worth $5 a share, then the collars did what they were supposed to do, they protected the wealth.[218]

How is an exchange fund any different than a tax shelter or allowing hedge fund managers to defer paying billions of dollars?[219] If one believes that there are similarities, then it is easy to envision a similar chain of events unfolding as took place in the hedge fund industry. The hedge fund industry went through its public offering bonanza during 2007.[220] This spurred Congress to begin "focus[ing] on the tax loopholes allowing these owner-individuals to monetize their carried interest at a significantly reduced tax."[221]

The argument for maintaining the current legislative rules is that after over fifty years[222] if they truly were a cause for concern, then legislation would have been enacted. However, there is very little if anything written on the subject.[223] Why would a multibillion-dollar industry have so little guidance?

In fact, there have been no congressional hearings or press on the merits of changing the law. There have been no hearings since Representative Neal's proposed legislation in 1999. In today's environment, one would expect that the arguments should center on the question of the fundamental fairness for a perceived tax preference for the wealthy. Assuming that Con-

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218. Collars also have other risks such as SEC reporting rules including volume limitation sale rules. *See* 17 C.F.R. § 230.144. Also, desired tax results are not specifically confirmed by Treasury Regulations.

219. *See generally* David J. Herzig, *Carried Interest: Can They Effectively Be Taxed?*, 4 ENTREPRENEURIAL BUS. L.J. 23 (2009).

220. *See, e.g.*, Fortress Investment Group LLC, Registration Statement (Form S-1) (Nov. 8, 2006), *available at* http://www.sec.gov/Archives/edgar/data/1380393/000095013606009310/file1.htm.

221. Herzig, *supra* note 219, at 25. *See also* David Cho, *Blackstone IPO Faces Roadblock in Senate*, WASH. POST, June 15, 2007, at D1 ("Publicly traded partnerships are rare, especially in the financial sector. The senators expressed concern that Blackstone's offering would set a dangerous precedent and lead to a wave of financial firms reorganizing themselves to take advantage of the tax loophole."); Lee A. Sheppard, *News Analysis: Blackstone Proves Carried Interests Can Be Valued*, 115 TAX NOTES 1236, 1237 (2007) [hereinafter Sheppard, *News Analysis*] (finding that the structuring in the Fortress and Blackstone initial public offerings created basis increases and tax savings not previously available).

222. *See Stop to the Swap*, *supra* note 114 (The first swap fund is attributed in 1960 to Denver Banker William M.B. Berger. He "had the bright—and right—idea that Section 351(a), which had been drawn to allow the tax-free transfer of property to a new corporation in exchange for stock, could also apply to individual stockholders. His Centennial Fund drew 191 investors, who pooled securities worth $25,800,000. Berger's idea has been widely copied. Boston's Vance, Sanders & Co. operates four funds currently worth $311.2 million.").

223. *See* Jackel & Sowell, *supra* note 57, at 1660.

gress desires to change the current law, as evidenced by the President's recent rhetoric,[224] the focus should be on the most effective solution.

Exchange funds are established for the purpose of avoiding investment company status.[225] The promoter of the fund sets up an entity with a predetermined set of assets at 80% marketable securities and 20% illiquid investments within the definition of either Section 351 or 721 depending on the type of entity.[226] The question that begs to be asked is: Why are these entities allowed to be formed for the primary purpose of avoiding investment company status?[227]

Treasury Regulations Section 1.701-2 provides that "if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal [income] tax liability in a manner that is inconsistent with the intent" of the partnership provision of the Code, the Service has the authority to recharacterize the transaction.[228] The Service can preclude the tax benefits sought under this authority.[229] Further, the investment company rules for reorganizations, Section 368(a)(2)(F), permits "ignor[ing] assets acquired for the purpose of ceasing to be an investment company."[230]

The promoters/proponents of the exchange funds argue that the aforementioned rules should not apply.[231]

> Tax counsel does not believe that treating a contribution of securities to a partnership as not currently taxable when the partnership does not come within the investment company definition expressly approved by Congress when it amended

224. *See* Obama for America, *supra* note 11.

225. *See, e.g.*, Sheppard, *Ruby Slippers*, *supra* note 8, at 1700 ("Greene Street's, uh, investment objectives show the overwhelming tax-avoidance motive of its formation."); Beldore, *supra* note 18, at 3 ("The Fund will also invest in certain assets that must constitute at least 20% of the Fund's assets in order for the exchange of contributed securities for Shares of the Fund to be non-taxable . . . .").

226. *See, e.g.*, Sheppard, *Ruby Slippers*, *supra* note 8, at 1700; Beldore, *supra* note 18, at 3.

227. The question has been asked and not answered before. *See* Sheppard, *Ruby Slippers*, *supra* note 8, at 1700-02; Sheppard, *Rationalizing*, *supra* note 90; Johnston, *supra* note 6.

228. Treas. Reg. § 1.701-2 (2009). *See also* Hesch & Manning, *supra* note 92, at 209 ("As a general proposition, because the investment company regulations comprehensively deal with transfers of securities to partnerships, the anti-abuse regulations should not apply when the family partnership arrangement is designed to void the specific provisions of §721(b).").

229. Under Treasury Regulation section 1.701-2, the service has outlawed many schemes, including tax shelters. *See, e.g.*, Jade Trading, LLC v. United States, 80 Fed. Cl. 11 (2007); Klamath Strategic Inv. Fund, LLC v. United States, 440 F. Supp. 2d 608 (E.D. Tex. 2006).

230. *See* Jackel & Sowell, *supra* note 57, at 1667-68. *See* I.R.C. § 368(a)(2)(F)(iv) (2006).

231. *See* Beldore, *supra* note 18, at 80.

> Code Section 351(e) in 1997 would be found to be inconsistent with the intent of the partnership provisions of the Code.[232]

This position, amazing as it may appear, seems to be supported by the Service.

In Private Letter Ruling 200017051, the Service took the position that when assets were "transferred to a partnership for the sole or primary purpose of avoiding investment company status," it was permissible.[233] After the death of the decedent, the family went through an overall reorganization of its assets.[234] Three trusts transferred various interests including marketable securities, promissory notes, and real estate interests, to a limited partnership.[235] The real estate interests were held in limited liability companies (LLCs).[236] The Service looked through the LLCs to the underlying assets and concluded that the qualifying assets were greater than 20%.[237] Thus, the partnership did not qualify as an investment company.[238] The ruling did not opine on the use of the LLC interests solely to avoid qualifying for investment company status.[239] However, the ruling did not negate that the only reason for qualifying was the basket of interests that the family put together.

As discussed *supra*, in most sophisticated exchange funds, there is a strong correlation between the 20% illiquid portion and the promoter of the fund.[240] For example, in the Eaton Vance fund, the qualifying assets are part of a newly formed real estate investment trust that is owned and operated by the promoter.[241] This is a similar structure to PLR 200017051. However, it seems disingenuous to state that this is any different than a Section 368 reorganization. The promoter set up an entity other than to accomplish a singular tax objective.[242] The promoter even went so far as to establish the illiquid portion of the fund and exercise control over that asset to allow the investor a further level of comfort.[243]

Why do the Service and Congress allow exchange funds to follow the letter of the Code here when the underlying premise of an exchange fund

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232. *Id.*

233. Jackel & Sowell, *supra* note 57, at 1668. *See also* I.R.S. Priv. Ltr. Rul. 200017051 (Apr. 28, 2000).

234. I.R.S. Priv. Ltr. Rul. 200017051.

235. *Id.*

236. *Id.*

237. *Id.*

238. *Id.*

239. *Id.*

240. *See generally* Beldore, *supra* note 18, at 3; Sheppard, *Ruby Slippers*, *supra* note 8, at 1700; BITTKER & LOKKEN, *supra* note 42, at ¶ 91.2.2; Jackel & Sowell, *supra* note 57, at 1678.

241. Beldore, *supra* note 18, at 3 ("The Fund expects to hold all or a substantial portion of its real estate investments through . . . a newly organized Delaware corporation.").

242. I.R.S. Priv. Ltr. Rul. 200017051 (Jan. 24, 2005).

243. *Id.*

fails? Section 351 of the Code was never designed to apply to these types of entities. To argue that the fund fits within the intent of the Code for tax avoidance one has to accept that the fund fails to meet the intent of the Code in formation.

VI. ADDITIONAL BENEFITS

It would have been expected that having a congressionally authorized diversification tool would have been sufficient for the fortunate few who held a security that the promoter of the exchange fund desired.[244] However, as is often the case with advantageous tax laws, the beneficiary of the accumulated advantage continues to look for further benefits.

A. Estate Planning

In the realm of exchange funds, the contributors continue to strain the tax system by often employing estate tax strategies.[245] One of the most common estate planning techniques is the "estate freeze."[246] An interesting aspect of the exchange fund is that not only is this type of a transaction contemplated, but it is also often specifically provided for in the limited liability company agreement.[247] For example, in one prospectus, a shareholder may divide his or her shares into a preferred component and a common component.[248] In that fund, the preferred shares are the current value of the stock and the common shares are the growth over the preferred.[249] Why would this be part of the agreement if it were not often utilized? In fact, the promoter of the exchange fund will use this as a selling point of the fund. Not only does the shareholder gain the tax advantage of tax-free diversification,

244. *See generally* Johnston, *supra* note 6; Sheppard, *Ruby Slippers*, *supra* note 8, at 1699 ("Swap funds, therefore, are for mere millionaires, rather than multimillionaires.").

245. *See* Beldore, *supra* note 18, at 12-13 ("In the event of the death of a Shareholder, the tax basis of the Shareholder's interest in the Fund generally will be increased or decreased to the fair market value of such interest as of the date of death or six months thereafter.").

246. In this transaction, the senior generation would either contribute an asset to a partnership-type entity or convert an existing entity into common and preferred shares. This manipulation of the ownership structure is designed to create a controlling class of shares and an equity class of shares. Once this conversion is completed, the senior generation will then sell to an entity (often a trust for the junior generation) the common shares. The senior generation will then retain the control shares. The sale of the interest will "freeze" the value for estate tax purposes. Thus, any growth on the assets after the sale will not be subject to the estate tax at the senior generation death.

247. *See* Beldore, *supra* note 18, at 100.

248. *Id.* This occurs within the "Estate Freeze Election" section of the PPM.

249. *Id.*

but he or she gets tax savings at death. So the shareholder gets to "cheat" the system twice.

Finally, even without using the aforementioned technique, upon death of a shareholder, the tax basis of the shareholder's interest in the exchange fund generally will be increased or decreased to the fair market value of such interest at the date of death.[250] The step-up in basis will be subject to the prescribed limits in 2010.[251]

B. Borrowing Against the Fund

The argument put forth by the Committee for Joint Taxation, which dismissed Representative Neal's proposed legislation in 1999, was that even if the law was changed, the wealthy would find alternatives that allowed the same tax-free diversification.[252] "The Congressional Joint Committee on Taxation, without any supporting data, has written [Representative] Neal to say that no revenue would be raised by closing exchange funds because 'the class of investors engaging in swap funds' would find other ways to avoid the tax."[253] What the Committee failed to discuss was that not only were the potential investors of the exchange fund utilizing the vehicles for tax-free diversification, but they were also borrowing out their original basis.[254] In effect, the potential investors would receive the best of both worlds.

Part of the selling point of the exchange fund is the ability to make distributions to an investor of his or her original basis.[255] Thus, assume that the investor has $5 million of XYZ corporation, a publicly traded NYSE stock. The investor paid (has a basis) of $1 million in the stock. The exchange fund promotes the following scenario to the investor—put in $5 million and at the end of seven years the fund will deliver a diversified portfolio of securities. Further, if the investor elects, over a three-year period, the fund will allow him or her to borrow out of the fund his or her original basis—in this case $1 million. At the end of the seven-year period, the investor would have a tax-free diversified portfolio and the ability to have invested the $1 million outside of the fund.[256]

When the Committee said that the investors would find another way to avoid tax, it was correct. The wealthy not only have continued to invest in the funds, but they have avoided the additional taxation that would normally

250. Or six months thereafter. Economic Growth & Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 §1022(a), 115 Stat. 38, 76 (2001).

251. *Id.*

252. *See* Jackel & Sowell, *supra* note 57, at 1682; Johnston, *supra* note 6, at C2.

253. Johnston, *supra* note 6, at C2.

254. Investment houses will allow margin account borrowings against Exchange Funds.

255. *See* Beldore, *supra* note 18.

256. *See generally id.*

exist in a borrowing situation and continue to maximize their tax-free growth.

CONCLUSION

The underlying fact that must finally be accepted is that exchange funds exist only for the purpose of avoiding taxation. Every part of the exchange fund is designed around a specific rule. The term of the fund, set at seven years, is designed to avoid Section 704(c)(1)(B). The 80%–20% asset breakdown exists only to avoid the investment company rules under Sections 351 or 721. The 20% illiquid security is specifically engineered for the fund to satisfy the tax code.

What is unclear is why Congress continues to allow this tax shelter to exist. Each time that legislation has been brought to the forefront, it has been dismissed in committee. Part of the problem is that no one really knows the extent of the industry. Another part of the problem is that it has the veneer of legitimacy. By having large financial institutions promote these funds and large law firms support the tax conclusions, investors do not question whether or not they are legitimate. However, when one sees that over $30 billion is invested in these funds, and considers the sophisticated investor rules, it becomes apparent that the wealthy remain the only beneficiaries of these investments, and there is no tax in sight. These rules should be reexamined.

Rather than following the Joint Committee on Taxation's advice to Representative Neal in his 1996 legislative proposal, and ignoring the problem because the rich will just find another way, there are two solutions to the enigma of exchange funds. The first solution is to merely change the rules in Sections 351 and 721 of the Code to prohibit the formation of these exchange funds. The current laundry-list approach must be eliminated. The ability of the financial markets to create security line instruments is unsurpassed. Congress and the treasury are unable to keep pace. Thus, the fundamental rules must be changed. Moreover, given the apparent misapplication of the underlying statutes, this does not appear to be an unreasonable approach.

There is also an intermediate attack on the exchange funds. Treasury can use the anti-abuse rules in Treasury Regulations Section 1.701-2 to prohibit the formation of these entities. There exists no apparent reason for the current acquiescence to this structure. The stated purpose of the exchange fund is to avoid taxation. Treasury should use the anti-abuse regulations to prevent exchange funds from being solely formed for tax avoidance.