

Are tax-efficient exchange funds for you?

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Throughout my career, I have counseled clients whose financial portfolios have included concentrated stock positions. These clients often express apprehension about the substantial proportion of their net worth tied to a single stock. They are also reluctant to sell the stocks, since the recognition of gain through sale would trigger the taxes associated with the significantly accrued capital gains.

After some discussion, many of these clients choose to explore exchange funds, which is a tax-efficient solution that I am often surprised is not considered.

Defining exchange funds and understanding when to consider them

An exchange fund is a partnership created for owners of concentrated stock positions, allowing them to diversify their concentrated stock position in a tax-efficient manner. This is done through contributing some, or all, of their concentrated stock into the fund in exchange for a partnership interest, resulting in the investor owning a portfolio of stocks all contributed by others in the same position.

Unlike selling and recognizing gain, the shares contributed to the exchange fund are not subject to immediate capital gains tax. The shares typically have a seven-year lock-up period in the fund. Depending upon the arrangement, the investor may be able to receive distributions after a specified amount of time within the seven years. After the lock-up period expires, the investor may leave the partnership and receive shares comprising the various marketable securities held by the fund, rather than cash.

This basket of shares addresses the desire for diversification while also allowing taxes to be further deferred until the stocks are sold. If the securities are held until the investor passes away, the securities will be valued at their fair market price (known as a step-up in basis), effectively and efficiently avoiding all capital gain tax on the appreciation.

This tax-efficient alternative to diversifying a concentrated stock position is a strategy that many find worth considering; however, implementation requires coordination with experienced advisors.

When does it make sense to move from a stake in concentrated stock to a stake in an exchange fund?

The decision to transition from a stake in concentrated stock to an exchange fund often makes sense when investors seek to mitigate the risks associated with overexposure to a single stock.

Dating back to the 1990s, exchange funds become particularly relevant during periods of heightened market volatility or when signals indicate potential challenges for the particular stock in question, such as impending regulatory changes, industry disruptions or company-specific issues. Market signals, such as significant fluctuations in the stock price or changes in the overall economic landscape, can serve as important indicators prompting investors to reassess their concentration risk and consider diversification strategies.

Implementing this strategy is contingent upon the exchange fund accepting the stock you want to diversify, choosing to incorporate your stock position into the fund. In my experience, clients are usually told within a few days if the exchange fund will accept their stock. In the event an exchange fund does not want to proceed with your stock, there are other avenues you can consider, such as implementation of collars or strategic stock sale intervals, to limit exposure to market fluctuations.

When exchange funds aren't the right choice

However, there are also scenarios where an exchange fund may not be as beneficial. Investors who plan to leave their concentrated stock portfolio to beneficiaries upon their death might find less value in an exchange fund. In such cases, the focus might shift towards the long-term perspective, with the goal of passing on the concentrated stock position to heirs. These investors may prioritize the potential for the stock to appreciate over time, for the sake of their beneficiaries, and they may not be as concerned about short-term market fluctuations, or the tax implications associated with diversification strategies.

Conclusion

Ultimately, the decision to move from a concentrated stock position to an exchange fund involves a careful evaluation of individual financial goals, risk tolerance and the broader market context. It requires a nuanced understanding of both the specific stock in question and the investor's overall wealth management strategy.

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