Exchange Funds vs 351 Transactions

An Evidence-Based Investor's Perspective

Evidence-based investors with concentrated low-basis stock positions face a tough decision. How do you diversify your allocation into an evidence-based solution in a tax-efficient way?

Exchange funds and 351 Transactions are two different solutions to this problem. This paper examines the pros and cons of each and compares them head-to-head to help evidence-based investors decide what is best for them and their clients.

Thankfully, the decision is surprisingly clear: There are virtually no scenarios in which an exchange fund is a better option than a 351 conversion.

Defining the Problem?

Evidence-based investors are well aware of the risks of holding individual stocks. Whether it's fraud (Enron), changing consumer preferences (Peloton), or new innovations (Blockbuster), every stock is subject to the risk of losing 80+% of its value over a short time period. Investors who have a material portion of their net worth in any single stock, or even a handful of stocks, are taking significant concentration risk that they are not compensated for with higher returns. However, the alternative of selling these concentrated positions, diversifying the proceeds and paying the subsequent tax bill can be painful. Therefore, what is the best way to move from single stocks to an evidence-based solution while minimizing the pain? Let's compare two solutions to this problem: Exchange Funds and 351 Transactions.

What is an Exchange Fund?

Exchange funds are private investment funds that help investors with concentrated, appreciated stock positions diversify their holdings. Investors contribute individual stocks to this private pool tax-free and, in exchange, get an ownership share of the pool. The goal of the fund is to attract lots of investors with different stocks and contribute them to the pool such that the entire pool becomes diversified. If the fund is successful, investors get exposure to a diversified basket of securities rather than an individual stock tax-free. In the future, an investor can redeem their position in the private fund and receive an in-kind, pro-rata slice of the current holdings in the fund tax-free. Thus, investors go from holding one concentrated stock position to a diversified basket of stocks tax-free. Sounds great!

What are the Important Limitations on Exchange Funds to Consider?

Unfortunately, no solution is perfect, and exchange funds come with numerous and important limitations.

- To redeem your shares tax-free you can't redeem for seven years. Thus, you become illiquid for seven years.
- Exchange funds are expensive. Typical annual fees are over 1%.
- The fund is usually limited to US large-cap stocks.
- Diversification is limited to the specific stocks investors contribute. Often, investors want to contribute the same stocks, and if the fund already has enough of the stock you want to contribute, you are out of luck or will be cut back on the number of shares that you can contribute.
- Since the fund is private, you need to be an Accredited Investor, file a K-1, and deal with all the other headaches and complexities that come with private investments…for at least seven years.
- The fund itself cannot rebalance. Since all the positions contributed are at large gains, the fund is limited in what trading it can do. The fund can reinvest dividends to increase diversification or pursue an evidence-based investment tilt, but that ability is limited as dividend yields might only allow for approximately 2% turnover per year.
- At the end of seven years, if you redeem, you receive a basket of highly appreciated stocks that you can't rebalance without incurring significant capital gains. Further, each redeeming investor usually only receives a portion of the total number of stocks in the fund. Thus, they are no longer as diversified as the former pool, thereby facing the non-diversification problem all over again.
- To qualify as an exchange fund, at least 20% of the fund must be in "qualified" assets. Typically, this investment takes the form of private real estate that is funded by using the stocks contributed as collateral. This creates leverage and additional risk in the fund. Further, an investor may already be overallocated to real estate or not want to hold real estate in their portfolio.

Thus, while an investor can diversify a single stock tax-free if they are willing to accept seven years of illiquidity, high fees, levered private real estate exposure, no tilts to stocks with higher expected returns, and the headaches involved with private funds. This is a difficult tradeoff relative to simply selling the position, realizing the gain, and investing in a tax-efficient evidence-based ETF. Certainly, at a high enough gain, this tradeoff becomes worthwhile and an Exchange Fund is worth it.

What is a 351 Transaction?

351 Transactions allow investors to seed an ETF with stocks and securities in a tax-free transaction. More specifically, individual investors (collectively, the "Transferors") can contribute a diversified portfolio of securities to a newly formed ETF (the "ETF") in exchange for shares of the ETF.

Under IRS Code Section 351(c), portfolios of stocks and securities that are already diversified, such as an ETF, can be treated as a diversified portfolio of stocks and securities such that they can be transferred to an investment company under Section 351(a). Under IRS Code Section 351(a), no gain or loss is recognized if the 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" (as defined in Section 368(c)) of the corporation.

Although not the only requirements for being treated as a tax-free contribution under Section 351, the above provisions highlight two important limitations on a 351 transaction that are important to focus on when contributing stock and securities to an ETF: Control and Diversification.

What are the Important Limitations on 351 Transfers to an ETF to Consider?

1. Diversification
The IRS does not want parties to be able to make non-taxable transfers to an investment company to achieve diversification of a non-diversified portfolio. Accordingly, the transfer to an investment company will be taxable unless the portfolio being transferred to the ETF is already diversified. Therefore, each transferor must meet the following diversification standards:

- No more than 25% of the value of the total assets being contributed can be the stock of any one issuer. In other words, the biggest position cannot be more than 25%.

- No more than 50% of the value of the total assets being contributed can be the stock of any five issuers. In other words, the top five positions cannot be more than 50%.

- In determining total assets, an investor must exclude cash and government securities.

- If an investor transfers a regulated investment company, like an ETF, the portfolio gets "look-through" treatment. In other words, an S&P 500 ETF would be considered diversified, not a single position, because the IRS "looks through" the portfolio to see that each underlying position held in that ETF is considered an individual position for purposes of the diversification rule.

2. Control
A transfer of assets by one or more parties solely in exchange for the stock of a registered investment company (an ETF) does not give rise to the recognition of gain or loss if, immediately after the transfer, those parties are in "control" of the ETF. "Control" is defined as the ownership of stock possessing 80% of the voting and non-voting power. For an ETF, this would mean owning over 80% of the shares of the ETF. At the launch of an ETF, the Transferors will constitute a control group and will have well over 80% of the value of the ETF. Subsequent contributors are not likely to qualify as Section 351 contributions.

Thus, an investor can diversify a single stock tax-free into a low-cost, evidence-based ETF if they meet the diversification requirements. These requirements can be met in two ways. First, by combining the single stock with other stocks or ETF investments. If the investor combines several assets to meet the diversification criteria, then they can use all of these assets as part of the 351 transaction and diversify tax-free. The second method would be to sell part of the concentrated position (realizing some gains) to meet the diversification criteria. The more outside investments (ETFs or stocks) that the investor has, the less the investor would need to sell to meet the criteria. At most the investor would need to sell 75% of their position to meet the criteria.

Comparing Exchange Funds to 351 Transactions

To create an apples-to-apples comparison, let us compare similar investment cycles for these two investment options. Let's assume an investor's entire portfolio of $100 is in one stock at zero basis, and they can either:

1.) Invest in an Exchange Fund that will give them diversified US large-cap exposure, hold it for seven years, redeem it, and receive a diversified basket of US large-cap stocks. Or,

2.) Sell 75% of the position and seed the proceeds, along with the remaining 25%, into an evidence-based ETF and hold it for seven years.

3.) Determining the value at the end of seven years for the Exchange fund is simple:

Starting Value	$100	
Cost Basis	$0	
Annual Return (net of fees)	8%	*Assumed return of US Large Cap Index*
Value after 7-years (pre-liquidation)	$171.38	
Value after 7-years (post-liquidation)	$137.11	*20% capital gains tax*

Comparing this to a 351 Transaction will have two important differences (one positive, one negative). First, the 351 Transaction will have a lower starting value because you need to pay the capital gains upfront (negative). However, the 351 Transaction will have higher expected returns due to lower fees and the ability to pursue an evidence-based investment strategy (positive).

Most US total market evidence-based funds have fees in the 15-25 bps range. For the purposes of this analysis, let's assume the highest fee (25 bps) and assume a below-market fee for an exchange fund (75 bps). Thus, all else equal, an investor would expect the ETF to outperform the Exchange Fund by 50 bps per year. However, the ETF is also able to rebalance tax-free and invest in stocks with higher expected returns. For example, Dimensional's US Core 2 strategy has an expected annual outperformance relative to the Russell 3000 of 1-2% per year. Again, let's be conservative and assume a 1% annual outperformance. Thus, in total we would expect the ETF to outperform the Exchange Fund by 1.5% per year.

The value at the end of seven years for the 351 Transaction is:

Starting Value	$100	
Cost Basis	$0	
Post Liquidation Value	$85	*20% capital gains tax on 75% of position*
Annual Return (net of fees)	9.5%	*1.5% return premium due to lower fees and factor tiltsl*
Value after 7-years (pre-liquidation)	$160.44	
Value after 7-years (post-liquidation)	$140.35	*20% capital gains tax*
Annual After-Tax Return Alpha	0.35%	*Relative to Exchange Fund*

This analysis assumes an unrealistic worst-case scenario of a zero-cost-basis position. The table below runs the same analysis for different levels of gains. The smaller the gain, the larger the return alpha for the 351 Transaction.

Gain	Annual After-Tax Return Alpha
Zero Cost Basis	0.35%
900% Gain	0.46%
400% Gain	0.56%
150% Gain	0.76%
100% Gain	0.86%
0% (No Gain)	1.30%

The benefit from the 351 Transaction comes from the annual higher return assumption. If we take the 400% gain scenario and compare different outperformance assumptions, we get the following results:

Outperformance Assumption	Annual After-Tax Return Alpha
50 bps fee + 0 bps factor outperformance	-0.31%
50 bps fee + 50 bps factor outperformance	0.13%
50 bps fee + 100 factor outperformance	0.56%
50 bps fee + 150 factor outperformance	1.00%
50 bps fee + 200 factor outperformance	1.44%

We have finally hit our first scenario where an Exchange Fund outperforms a 351 Transaction. An investor with a position at a 400% gain or greater and getting no additional returns from an evidence-based investment as compared to an index.

As you can see from this analysis, the benefits of lower fees and the ability to invest in an evidence-based strategy outweigh the negative upfront tax hit that you suffer from a 351 Transaction. Keep in mind that this analysis assumes you suffer the maximum tax hit upfront. If you combine your concentrated stock position with any other ETF or stock that can materially lower the tax burden and further improve the prospects of a 351 Transaction relative to an Exchange Fund.

This analysis has been a purely mathematical comparison and there are other externalities that further solidify a 351 Transaction as the better choice.

Other Considerations

Liquidity

Once the assets are invested in an Exchange Fund, you can't redeem the position without severe penalties. In addition, if other investors choose to redeem early, that will trigger a taxable event for *all* investors in the fund, not just the redeemer.

In contrast, ETFs are daily liquid, and the actions of other investors do not affect you. Thus, a 351 Transaction preserves liquidity for the investor and eliminates the risk of other investors imposing tax consequences on you.

Private Fund Headaches

Exchange Funds are private pools of capital that produce annual K-1s and can only be accessed by qualified investors. ETFs are publicly traded funds that sit in your brokerage account as a line item, just like any other stock, ETF, or mutual funds in your portfolio and don't require any unique tax treatment.

Limited Access

To maintain the diversification benefit, Exchange Funds must limit which stocks they accept into the pool. The pool doesn't work as a diversifier if everyone adds Mag 7 stocks to it. In most cases, investors hold the same stocks at large gains because only a handful of stocks in the market have outsized returns. Thus, most investors are left without an option.

This is not an issue for 351 Transactions into ETFs for two reasons. First, what is seeded must be diversified (no more than 25% in one stock). Second, ETFs can rebalance into higher expected return stocks without realizing capital gains. Thus, the ETF is not concerned with getting too much of one position and does not limit the types of stocks that are invested.

Diversification

Although an Exchange Fund improves diversification, it is limited to the stocks other investors add to the pool and does not have a method of rebalancing to ensure an investor holds most of the stocks in the market. In addition, the investor is exposed to 20% private real estate in the pool, which will produce annual taxable income.

ETFs can rebalance and invest across the US Market, including small and micro-cap companies. They contain no private real estate exposure. In addition, the strategy can tilt toward stocks with higher expected returns.

Flexibility Improves Results

The initial tax hit to sell part of your concentrated position for a 351 Transaction can be mitigated by using other stocks or ETFs. By combining multiple assets to meet the diversification criteria, investors can clean up expensive or concentrated legacy holdings and migrate to a low-cost, evidence-based, tax-efficient investment solution.

info@longviewresearchpartners.com
longviewresearchpartners.com