EXCHANGE FUNDS: THE TAX CONSEQUENCES OF A TRANSFER OF APPRECIATED STOCK TO A PARTNERSHIP OR A MUTUAL FUND

I.

INTRODUCTION

Suppose an owner-founder, or a senior executive of a company exercised stock options during a long association with a company, or an investor who had long held stock in a company, wanted to diversify his holdings. If his present stock was worth $100,000 but cost only $10,000, the $90,000 difference would not be realized until the stock was disposed of in a commercial transaction. A common method to obtain diversification would involve a transfer of appreciated securities for the stock of several companies. Since a transfer would involve a disposition of stock with a substantially higher market value than cost, immediate gain normally would be recognized. Presently, a way to avoid immediate capital gains treatment, while diversifying investment securities, entails the transfer of appreciated stock to an exchange fund for shares in the fund.

II.

EXCHANGE FUNDS

An exchange fund is an investment device which enables persons holding blocks of securities to obtain diversification by exchanging their individually held securities for shares in a supervised and diversified portfolio.[1] The benefit of investing in a diversified portfolio is that the risks involved in ownership of one common stock can be reduced by sharing the risk of loss with investors in many different industries. Also, by pooling the dividends, gains can be spread among the various investors continuously and with certainty because investors are no longer singularly subject to fluctuating market conditions.

The mechanics of the exchange requires that prospective investors deposit their stock certificates with a depository, for example, a bank. After numerous investors have done likewise, the fund selects which investors' securities it will accept for the exchange. Since the fund's objective is to obtain long term growth and diversification, the fund typically will accept blue chip stocks from different industries. When stocks have been accepted by the exchange fund, the fund issues its shares in return.

Normally, such a transfer would involve capital gains. However, in order to avoid immediate tax on the transfer of appreciated securities, the exchange fund can be operated as a limited partnership since neither

1. The major source of how an exchange fund operates is The Vance, Sanders Exchange Fund Prospectus, dated January 5, 1976, issued by Vance, Sanders and Company, Boston, Massachusetts. For related stories see The Wall Street Journal, Jan. 4, 1976, at 1, col. 5; Business Week, Feb. 16, 1976, at 70.

gain nor loss will be recognized by a partnership or its partners on a contribution of stock or securities in exchange for an interest in the partnership.[2] Although this transfer of securities to the partnership creates a new interest in the partner, the transaction is not a taxable event.[3] The result should be contrary, and gain or loss on such a transfer should be recognized, if the transfer is to a corporation, or a regulated investment company.

The significance of an exchange fund falling within the definition of a Regulated Investment Company or Corporation would be to deny nonrecognition to the initial exchange. As a general rule, no gain or loss will be recognized if property is transferred to a controlled corporation solely in exchange for stock or securities in such corporation.[4] However, this general rule does not apply and, consequently, gain or loss will be recognized where property is transferred to an investment company.[5] A transfer of property will be considered to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor's interests, and the transferee is a regulated investment company or a corporation more than 80% of the value of whose assets are held for investment and are readily marketable stocks or securities.[6] Therefore, as long as the fund qualifies as a partnership rather than a corporation, the initial exchange will be tax free.

Since organizations which are not partnerships under local law may nevertheless be taxable as such,[7] the statutory definition of a partnership

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2. INT. REV. CODE OF 1954, § 721 [hereinafter cited as *IRC*]; Vance, Sanders Private Ruling dated April 28, 1975 [hereinafter cited as *Private Rul.*].

3. J. CHOMMIE, THE LAW OF FEDERAL INCOME TAXATION 504 (2d ed. 1973).

4. IRC § 351.

5. Treas. Reg. § 1.351-1(c)(1) (1967) [hereinafter cited as *Reg.*].

6. Reg. § 1.351-(c)(i), (ii). IRC § 851(a) defines a regulated investment company as any domestic corporation, other than a personal holding company which during the entire taxable year is registered under the Investment Company Act of 1940, *as amended* (15 U.S.C. §§ 80a-1 to 80b-2) either as a management company or a unit investment trust, or which is a common trust fund or similar fund excluded by Section 3(c)(3) of said Act, and which is not included in the definition of common trust fund by Section 584(a) of the 1954 Code.

A personal holding company is generally a corporation which at least 60% of its adjusted gross income is personal holding company income, *i.e.*, consists of dividends, interest, royalties (other than mineral, oil, or gas royalties or copyright royalties) and annuities, and more than 50% of its stock is owned directly or indirectly by not more than five people.

Unit investment trust means an investment company which is: (a) organized under a trust indenture, contract of custodianship or agency, or similar instrument, (b) does not have a board of directors, and (c) issues only redeemable securities each of which represents an undivided interest in a unit of specified securities; but it does not include a voting trust. 15 U.S.C. § 80a-4(2).

Section 3(c)(3) of the Investment Company Act excludes any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian.

7. Treas. Reg. § 1.761-1(a) (1972); *see also* ARONSON, PARTNERSHIP INCOME TAXES 221 (1974).

will control as to the tax treatment of the entity. The definition of a partnership is actually a negative one since it depends upon the absence of a trust, estate or corporation.[8] Whether or not an organization more nearly resembles a corporation than either a partnership or trust is the relevant test in determining if an unincorporated organization is an association for tax purposes.[9]

This test has been embodied in the Regulations in determining whether an organization will be classified as an association taxable as a corporation.[10] In the final estimation, if the organization possesses more corporate than non-corporate characteristics, then regardless of form or label it will be treated as a corporation for tax purposes.[11]

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8. IRC § 761(a), (b); § 7701(a)(2). Under the Internal Revenue Code § 7701(a)(3) a corporation is defined to include associations, joint stock companies, and insurance companies. The term associate refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization, such as a partnership or a trust.

9. Morrissey v. Commissioner, 296 U.S. 344 (1935).

10. Treas. Reg. § 301.7701-2(a)(3) (1965); for a discussion of whether a limited partnership will be taxed as an association, *see* Note, *Phillip G. Larson*, 1 DEL. J. CORP. L. 96 (1976).

11. IRC § 7701; Reg. § 301.7701-2 (1965).

There are a number of major characteristics found in a pure corporation which, taken together, distinguish it from other organizations: Associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit, the absence of these characteristics will cause an arrangement not to be classified as an association. Reg. § 301.7701-2(a)(2).

An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. If an agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if no member has the power to dissolve the organization in contravention of the agreement. A general or a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act both lack continuity of life. Reg. § 301.7701-2(b) (1965).

An organization has centralized management if any person or group has continuing exclusive authority to make the management decisions. Because of the mutual agency relationship between members of a general partnership, such a general partnership cannot achieve effective concentration of management powers and, therefore, centralized management. Limited partnerships generally do not have centralized management unless substantially all the interests in the partnership are owned by the limited partners. Reg. § 301.7701-2(c) (1965).

An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. In the case of a general partnership, personal liability exists with respect to each general partner. An organization formed as a limited partnership, lacks personal liability with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor. In effect, unless general partners of a limited partnership can be reached by creditors, the limited partnership has the corporate characteristic of limited liability. Reg. § 301.7701-2(d) (1965).

An organization has the corporate characteristic of transferability of interests if each of its members, or those members owning substantially all of the interests in the organization, have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. Reg. § 301.7701-2(e) (1965).

The key characteristics in determining whether the exchange fund will be taxed as a partnership are continuity of life, and limited liability since the other characteristics are more or less common to all business organizations. In the case of a limited partnership, continuity of life does not exist if the limited partnership dissolves upon the retirement, death or insanity of a general partner unless the remaining general partners or all remaining partners agree to continue the partnership.[12] Although a favorable advantage to the limited partners is limited liability, such limited liability is clearly a corporate characteristic which must be avoided at least as to one of the partners. If the general partners have substantial assets in excess of their partnership interest which can be reached by creditors, the fund will lack the corporate characteristic of limited liability.[13]

To ensure that an exchange fund will be treated as a partnership, the fund could request a private ruling. In order to obtain a favorable private ruling as to its tax status, an alleged limited partnership must show[14] that it has a viable general partner who has a real interest in the partnership affairs. His real interest can be shown by possessing at least a 1% interest in each material item of income, gain, loss deduction and credit at all times during the partnership's existence. Certain transactions described as non-recourse loans must be neither disguised equity interests nor transactions which are not bona fide loans. Also, the aggregate tax deductions for the first two years of operation must not exceed the total equity invested in the partnership. In addition, all documents and materials used in promoting and selling interests in the partnership must be submitted with the application for a private ruling.

III.

PARTNERSHIP AND MUTUAL FUND OPERATIONS

The avoidance of immediate gain upon the transfer of stocks to a partnership probably would motivate investors holding appreciated stocks to transfer the stock to a partnership rather than to a mutual fund company. As mentioned earlier, the exchange of appreciated securities for shares in a regulated investment company should be a taxable exchange.[15] Although the goal of a mutual fund company to have a diversified portfolio is similar to the goal of a partnership exchange fund, different tax consequences result when a fund operates as a mutual fund company rather than a partnership.

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12. Reg. § 301.7701-2(b) (1965); *see also* Glender Textile Co. 46 B.T.A. 176 (1942).

13. Reg. § 301.7701-2(d) (2); Private Rul.

14. Rev. Proc. 74-17, 1974-1 I.R.B. 17.

15. *Supra* note 6.

A mutual fund company is a synonym for a Regulated Investment Company, especially an open-end management investment company,[16] whose primary purpose is to engage in the business of investing and reinvesting in securities of other companies.[17] The largest group of investment companies consists of management companies which may be organized as corporations, unincorporated associations or business trusts.[18] An open-end diversified investment company is one which is offering, or has outstanding, any redeemable security, i.e. which entitles the holder on demand to receive approximately his proportionate share of the issuer's net assets or its cash equivalent.[19] A mutual fund may make a irrevocable election to be taxed as a regulated investment company provided it fulfills certain requirements.[20]

In order to be taxable as a regulated investment company, a mutual fund must come within the definition of a regulated investment company[21] and meet other conditions. A corporation will not be deemed to be a regulated investment company for any taxable year unless at least 90% of its gross income is derived from dividends, interest and gains from the sale or other disposition of stock or securities and unless less than 30% of its gross income is derived from the sale or other disposition of stock or securities held for less than 3 months.[22] Generally, in addition to the gross income requirement, it is necessary that as of the close of each quarter of the taxable year at least 50% of the value of the company's total assets must be represented by cash and cash items (including receivables), Government securities, securities of other regulated investment companies and other types of securities.[23] Regulated investment companies, in order to be taxable as such, must also distribute to their stockholders at least 90% of their investment company taxable income, exclusive of capital gains, and if they do so, they are taxable as ordinary corporations only on the amount of their investment company taxable income which is not distributed.[24]

Aside from the avoidance of immediate gain upon the transfer of stocks to a partnership, there are other advantages resulting from an exchange fund's operation as a limited partnership. Since the fund issues limited partnership interests, the liabilities of the partnership could only be satisfied to the extent of the limited partner's interest in the fund. Of course, since the general partners must have substantial assets in excess of their

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16. L. LOSS, SECURITIES REGULATION 146 (2d ed. 1966) [hereinafter cited as Loss].
17. *Id.* at 144.
18. *Id.* at 145.
19. § 2(a) (31) Investment Act Co. of 1940, 15 U.S.C. §§ 80a-1 to 80b-2 What makes a diversified company is actually a mathematical test of the degree of diversification of the company's portfolio. Loss, at 146. *See also* 15 U.S.C. § 80a-5.
20. IRC § 851(b)(1).
21. *Supra* note 6.
22. IRC § 851(b)(2), (3).
23. IRC § 851(b)(4)(A)(i), (ii).
24. Treas. Reg. § 1.852-1 (1962).

partnership interest available to meet the fund's possible liabilities, the fund's creditors could reach the general partner's additional assets.[25] However, the limited partners enjoy the same benefit of mutual fund shareholder's limited liability. Although mutual fund shareholders may not usually report ordinary losses realized by the corporation on their individual tax returns, should a partnership realize operating losses, the losses may be offset against the partner's ordinary income.[26]

Another advantage of the partner-partnership relationship is the avoidance of double taxation which usually results when a corporation distributes its profits to shareholders. The income of a corporation is taxable to it as an entity and again to the shareholders who receive the benefits of the corporation's success. Because a partnership itself is not a taxpaying entity, its profits are taxed only to the partners.[27] Each partner is separately taxed on his distributive share of the partnership's items of taxable income. Said distributive share is usually determined by the partnership agreement.[28]

A corporation operating as a mutual fund company also avoids most of the double taxation effect if it distributes its taxable income to the shareholders.[29] When a shareholder receives his pro rata share of the mutual fund's profits in the form of dividends, the shareholder includes such sums on his individual tax return.[30] Such sums distributed provide a deduction for the mutual fund which lessens its tax liability.

Assuming that the exchange fund realizes profits or capital gains, the character of the items remains the same when the partner files his tax return. Since each member of a partnership must individually report his distributive share of the partnership's income, gains, loss deductions and credits whether or not any actual distribution is made to him,[31] this avoids accumulation of losses as well as non recognition of partnership income. If the partnership realizes long term capital gains, each partner must account for his pro rata share of such capital gains regardless of the holding period of his partnership interest.[32] When a regulated investment company (mutual fund) distributes capital gains dividends, the stockholders are required to treat such capital gains dividends when received as gains from the sale or exchange of capital assets held for more than six months.[33]

When the exchange fund realizes income or loss items which are then distributed to the partners, each partner's basis for his interest in the partnership must be increased or decreased by his distributive share of the partnership's realized gains and losses.[34] The original basis for a partner's

25. *Supra* notes 12, 13.
26. IRC § 702(a). *See* ARONSON, *supra* note 7, at 259.
27. IRC § 701; Treas. Reg. § 1.701-1 (1960).
28. IRC § 704(a); Treas. Reg. § 1.704-1(a) (1964).
29. *Supra* note 24.
30. Treas. Reg. § 1.852-4(a) (1974).
31. IRC § 702(a); Treas. Reg. § 1.702-1(a) (1972).
32. Rev. Rul. 68-79, 1968-1 C.B. 310.
33. IRC § 852(b)(3)(B).
34. IRC § 733.

interest in the exchange fund is equal to the basis of the property contributed to the partnership.[35] Where a partner acquires his interest from another partner, his basis is generally the acquisition cost,[36] and if the interest is inherited, the legatee generally takes for his basis the fair market value of the interest at the time of the decedent's death.[37] The same rules generally apply when a shareholder acquires his interest in a corporation.

Once a partner has realized taxable income with respect to an item received by the partnership, it is necessary to adjust the basis of his partnership interest so that no further gain or loss will result to him should he later sell his interest. This basis adjustment avoids double taxation because the tax has already been accounted for by the partner's payment of tax.[38] A partner's basis is adjusted upward for his share of undistributed profits on which he is taxed because, if the profits are not distributed, his capital account nevertheless increases. Generally, a partner's basis is increased by his distributive share of the partnership's taxable income, including capital gain; and decreased by his distributive share of the partnership's realized losses.[39] Since corporate income and losses are taxable to the corporation and since shareholders are taxed only when, and if, the corporate income is distributed to them, there are no basis adjustments provided or necessary for each shareholder's interest.[40] However, where a regulated investment company has undistributed capital gains, each shareholder must report his share of such undistributed capital gains. The undistributed capital gains must be treated as long term capital gains, and each shareholder will increase the adjusted basis of his stock by 70% of the capital gains recognized.[41]

When a partnership makes a profit, each partner's capital account is increased by leaving the profits in the business. Or stated another way, each partner must report his distributive share of partnership income whether or not he withdraws it,[42] and this realization of income results in an increase in the basis of his partnership interest. If the partnership actually distributes profits later, it is a non taxable return of capital which reduces each partner's basis for his interest in the partnership.[43] In effect, the taxable event was the prior realization of income by the partnership, and then realized pro rata by the partners. The constant upward and downward shift in the basis will eventually cancel each other out, leaving

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35. IRC § 722.
36. Treas. Reg. § 1.742-1 (1960).
37. IRC § 1014(c); Treas. Reg. § 1.1014-1(c)(1) (1973); *supra* note 36.
38. *See generally* CHOMMIE, *supra* note 3, at 514, 515; ARONSON, *supra* note 7, at 61.
39. IRC § 705(a)(1)(A); Treas. Reg. § 1.705-1(a)(2)(i), (3)(i) (1960).
40. *See generally* B. BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 1.02 (3d ed 1971).
41. Treas. Reg. § 1.852-4(b)(2)(i), (iii), (c) (1974).
42. This avoids an accumulation of earnings to go untaxed because they are constructively received.
43. IRC § 733.

each partner with basically the same basis for his interest as when he acquired it.[44]

The realization by the partnership of profits might motivate it to retain those profits and issue shares of the fund in lieu of distributing those profits. Such current distributions in kind, whether pro rata or non pro rata, do not result in gain or loss to either the partner receiving the distribution,[45] the partnership or any of the non distributee partners[46] regardless of the fair market value or basis of the property so distributed. The basis of the property distributed is the partnership's adjusted basis for such property immediately prior to the distribution.[47] A retention of profits by a regulated investment company could have disastrous tax consequences. In order to be taxable as such, a regulated investment company must distribute to its stockholders at least 90% of its investment campany taxable income, exclusive of capital gains. Unless the distribution is made it will be taxed as a corporation on the income which is not distributed.[48]

As previously mentioned, the exchange fund becomes diversified by selecting different securities at the initial exchange and then holding them in its portfolio. While the initial exchange is tax free, the result would be different if the fund exchanged or sold the securities deposited to obtain diversification, or sold part of the portfolio in order to meet administrative costs. Since the partnership's basis for contributed property is the same as the basis of such property in the hands of the contributing partner,[49] any difference between the value of the property and its basis at the time of contribution will be recognized as a gain if the property is sold by the partnership at its market value.[50] Likewise, when a regulated investment company sells stocks to further diversify its holdings, capital gains will result if the stocks have a higher market value than cost. Because an exchange fund's portfolio contains a large number of appreciated securities, the fund will try to keep sales and transfers to a minimum.

Although the object of the exchange fund is to maintain a low portfolio turnover, there may be partners who want to sell their partnership interests. Any gain or loss realized by a partner upon the sale of his partnership interest will be measured by the difference between his adjusted basis for his partnership interest and the price he receives for it upon a sale to a transferee partner.[51] The basis of the partnership's assets will not generally be affected by such a sale.[52] Similar results should occur

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44. *See generally* CHOMMIE, *supra* note 3, at 520; ARONSON, *supra* note 7, at 95.
45. Treas. Reg. § 1.731-1(a) (1960).
46. IRC § 731(b); *id.* (b).
47. IRC § 732(a)(1); Treas. Reg. § 1.732-1(a) (1960).
48. *Supra* note 24.
49. IRC § 723.
50. IRC § 1001.
51. IRC §§ 741, 1001(a).
52. IRC § 743(a); Treas. Reg. § 1.743-1(a) (1960).

when a shareholder sells his interest in a mutual fund to a transferee shareholder.

When a partner sells his interest, the transferee or successor partner may often have a tax basis for the transferred interest which is different from the tax basis of the interest held by the former partner. This might result because the transferor partner had as his basis the value of the property he initially exchanged,[53] while the transferee successor partner takes his acquisition cost as his basis.[54] Similarly, where there has been appreciation in the value of the partnership assets and the consideration paid to the transferor for his interest exceeds his basis for such interest, the successor partner would want an adjustment to the partnership's basis for the property it holds to reflect the successor partner's higher acquisition cost.

Normally, the difference in the basis for the transferred partnership interest does not result in any increase or decrease in the tax basis of assets held by the partnership.[55] As a result, a new partner may find himself taxable with respect to his share of the appreciated securities should the partnership sell those assets. If transferor partner contributed appreciated stock which cost $10,000, his basis for sale remains $10,000 and the partnership's basis is also $10,000. Should successor partner purchase transferor's interest for $50,000, transferor recognizes $40,000 gain and successor partner takes a basis of $50,000 for his partnership interest. When the partnership subsequently sells the $10,000 stock at its then current market value, capital gains will be distributed pro rata to all the partners holding interests in the partnership. Thus, successor partner will pay capital gains on an interest which cost him more to acquire.

To avoid the possible unfavorable tax consequences on the successor partner, the partnership may make an irrevocable election to increase its basis whenever the transfer of an interest occurs. The increase is designed to reflect the successor partner's higher acquisition cost. Any increase in the basis of the partnership's assets affects only the transferee partner, and the partnership retains its old basis for its assets with respect to the remaining partners. When the election is made, the partnership's assets will have two bases, a special basis for the successor partner, and another basis for the partnership in general.[56] Such an election cannot be made by a regulated investment company.[57]

Different consequences from a sale or exchange might result when a partner decides to liquidate his interest in the exchange fund. The liquidation of a partner's interest means the termination of a partner's entire interest by means of a single distribution, or series of distributions.[58] In

53. *Supra* note 34.
54. *Supra* note 35.
55. *Supra* note 49.
56. IRC §§ 734, 743, 754; *see also* ARONSON, *supra* note 7, §§ 9.1 *et seq.*, 14.3 *et seq.*
57. *See* IRC §§ 851–55.
58. IRC § 761(d); Treas. Reg. § 1.761-1(d) (1972).

general, no gain or loss will be recognized by the partnership as a result of distributions in liquidation of a partner's interest.[59] The distributions to the partner might take the form of cash, property or both.

The best distribution in liquidation would seem to be a transfer of the same stock that the partner initially contributed to the exchange fund because a distributee partner's basis for the stock is equal to the adjusted basis of his interest in the partnership.[60] Even though the stock had appreciated before the initial exchange and may have appreciated in the hands of the partnership, the stock retained the same basis as the partner's interest. If the liquidating partner only receives what he contributed, there could be no gain on the transaction.

If the partner receives cash and property, his basis in the property distributed to him would equal the adjusted basis of his interest in the partnership reduced by the amount of money distributed in the same transaction.[61] If the amount of money distributed did not exceed the partner's adjusted basis in the partnership, the result of a distribution of the same stock that he initially contributed should result simply in a reduction of his basis in the stock received. If the distributee partner does not receive the same stock in return, which has a higher basis, or if the amount of money exceeds the basis of his partnership interest, then any gain recognized as a result of the distribution will be characterized as capital gain.[62]

When the distributee partner takes cash as his liquidating distribution, he recognizes gain to the extent that the amount of money received exceeds the adjusted basis of his partnership interest.[63] Because the business of the exchange fund is dealing in appreciated securities, each of the partners should have a lower partnership interest basis than the actual market value of the fund's portfolio. Therefore, the distributee partner could not expect to receive the fair market value of the stocks he initially contributed without recognizing large capital gains.

Generally, no gain or loss will be recognized to a regulated investment company on the distribution of property to a shareholder in partial or complete liquidation.[64] If the property is received in a distribution in partial or complete liquidation, by a distributee shareholder, the basis of the property in the hands of the distributee is the fair market value of the property at the time of the distribution.[65] Because a shareholder in a mutual fund took as his basis the fair market value of his property transferred, he probably paid tax on his appreciated stock at the time of transfer, therefore, his capital gains upon liquidation should generally be lower than a partner's liquidation of his exchange fund interest.

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59. IRC § 731(b); *supra* note 45, (b).
60. IRC § 732(b); Reg. § 1.732-1(b) (1956).
61. *Id.*
62. IRC § 731(a); Reg. § 1.731-1(a) (3) (1956).
63. IRC § 731(a)(1).
64. IRC § 336.
65. IRC § 334.

IV.

CONCLUSION

The main purpose of a mutual exchange fund was to allow investors to have a diversified share of the stock market while escaping immediate capital gains tax otherwise applicable on a similar transaction. When transfers to controlled corporations operating as investment companies became taxable, the growth of mutual exchange funds was halted. Since current exchange funds are operated as partnerships, they achieve similar results and allow investors to diversify their concentrated holdings without paying immediate capital gains tax. Thus far, investments purportedly totaling $475 million have been accepted by five partnership exchange funds.[66]

At the time of this writing, the United States House of Representatives has moved to conform the partnership tax rules to those for corporations in the case of exchange funds.[67] The bill would make taxable the transfer of appreciated stock or securities to an investment company organized as a partnership if the transferor's interests are diversified by the exchange. Several reasons motivate this author to respectfully suggest that the Senate of the United States not adopt this bill.

Since the bill would have a retroactive effect to exchanges occurring after February 1, 1976, and none of the funds had actually consummated exchanges before that date,[68] special "grandfather" rules have been written in to make five of the present exchange funds non-taxable.

Generally, to qualify for the special "grandfather" rules, the partnerships must have filed an application for or received a Private Ruling on or before February 17, 1976, and if required to do so, filed a registration statement with the Securities and Exchange Commission on or before that date. Also, the final binding exchanges of deposited stocks must occur within 90 days of enactment of the bill into law.[69] The insertion of the "grandfather" provisions was evidently in response to the funds which claimed detrimental reliance on the Vance Sanders Private Ruling, and consequently expended time and money for solicitation and organizational purposes.[70]

Because of the February 17, 1976 deadline, two of the present partnership exchange funds will be denied tax free exchange treatment.[71] Although it appears that all of the present exchange funds followed Vance Sanders precedent, the time at which they started organizing should be of

66. The Wall Street Journal, Apr. 8, 1976, at 3, col. 2; May 12, 1976, at 38, col. 1.

67. H.R. 11920, 94th Cong., 2d Sess. (1976).

68. HOUSE COMMITTEE ON WAYS AND MEANS, *Tax Treatment of Partnership Exchange Funds and Mergers of Investment Companies*, 94th Cong., 2d Sess. 7 (1976).

69. For a full text of the bill and explanation, *see* 6 P-H 1976 Fed. Taxes ¶ 59,327 *et seq.*

70. Vance Sanders alone incurred expenses of $546,000. *See supra* n.68, at 11-13.

71. The Chestnut Street Exchange Fund and Equity Exchange Fund both filed Ruling requests on March 26, 1976, *ibid.* 8.

little import. If the "Grandfather" rules are justified on the basis of detrimental reliance, the substance of all present exchange funds' reliance should be the deterimining factor in granting the special provisions.

Aside from the fact that the "grandfather" rules will not be applied to all the exchange funds, a more compelling reason dictates that the present bill not be adopted. No provisions would make taxable the transfer of appreciated property to a partnership other than an investment company. Thus a partner could continue to transfer appreciated stock, land, or other property to a partnership without incurring tax. In a sense, such a partner's interest becomes diversified because it is commingled with other partner's assets, a situation analogous to an exchange fund. This author fails to see the equity in allowing one partner a tax free exchange while denying it to one in a different business.[72]

John A. DiCicco

COMPULSORY, NON-CONTRIBUTORY PENSION PLANS ARE CLASSIFIED AS SECURITIES SUBJECT TO THE ANTI-FRAUD PROVISIONS OF THE SECURITIES LAWS

Daniel v. International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America[1]

The United States District Court for Northern Illinois, per Judge Kirkland, rejecting the Securities and Exchange Commission's long held opinion that an *involuntary, non-contributory* pension plan does not involve a "sale" of securities, declared such union pension plan to be within the purview of the Securities Act of 1933[2] and the Securities Exchange Act of 1934[3] and their respective anti-fraud provisions.[4]

72. It should be noted that several existing provisions discriminate against corporate securities. For example, they are expressly excluded from nonrecognition upon like kind exchange. IRC § 1031(a).

1. CCH FED. SEC. L. REP. ¶ 95,453 (N.D. Ill. March 1, 1976).
2. 48 Stat. 74, *as amended*, 15 U.S.C. §§ 77a to 77aa (1958).
3. 48 Stat. 881, *as amended*, 15 U.S.C. §§ 78a to 78jj (1958).
4. Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a). Section 17(a). It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Securities Exchange Act of 1934, § 10b, 15 U.S.C. § 78j(b). Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or