TAX POOLING AND TAX POSTPONEMENT—THE CAPITAL EXCHANGE FUNDS

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AN individual who owns a sizable block of stock in a public corporation, and who has had the pleasure of watching that stock appreciate in value over a period of years, frequently feels a need to diversify his holdings. The decision to diversify would normally involve a sale of the appreciated stock for cash and a reinvestment of the proceeds. However, a sale for cash will occasion the imposition of a capital gains tax equal at the maximum to 25% of the gain realized,¹ whereas no tax is imposed if the securities are simply retained. Since there is thus a difference in tax cost between selling and retaining an appreciated asset, the investor wishing to diversify is obliged to take the tax penalty into account and to consider whether the benefits of diversification are really worth a substantial reduction in his personal wealth. The question is presumably a difficult one, and the investor's reluctance to suffer an immediate and highly visible impairment of capital may ultimately lead to the abandonment of what otherwise would commend itself as a sound personal investment goal.²

The so-called capital exchange fund³ is a response and perhaps a solution to the familiar dilemma of the successful investor who is locked-in to existing investments by the threatened imposition of the gains tax. Capital exchange funds are mutual funds⁴ formed through

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1. Int. Rev. Code of 1954 § 1201(b) [hereinafter cited as IRC].

2. See Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957); Holt & Shelton, *The Lock-in Effect of the Capital Gains Tax*, 15 NAT'L TAX J. 337 (1962).

3. Capital exchange funds are also known as swap funds, deposit funds, diversification funds, tax-free exchange funds, and Centennial funds. The last denomination is in honor of the pioneer organization in the field.

4. The term "mutual fund" refers to an open-end diversified management investment company which is registered under the Investment Company Act of 1940. In contrast to closed-end investment companies, which have a stable capital structure, mutual funds stand ready at all times to redeem outstanding shares and in most cases are also engaged in a continuous offering of new shares to the public. Mutual fund shares are redeemed

the acquisition of securities from large numbers of individual investors solely in exchange for shares of the fund. 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, which provides that gain or loss shall not be recognized if property [the appreciated securities] is transferred to a corporation [the fund] by one or more persons [the investors] solely in exchange for the corporation's stock or securities [shares of the fund], and such person or persons are in control of the corporation immediately after the exchange. Since an ordinary sale of appreciated securities is a taxable event,⁵ this claim to tax-free treatment under section 351 has considerable significance from the investor's standpoint. If it is valid, a technique has been discovered by which an individual stock owner can convert an existing and appreciated investment commitment, uneasily represented by a substantial position in one or a small number of securities, into "investment company shares representing an interest in a diversified portfolio of comparable quality, having sound investment management, without the realization of gain or loss for federal income tax purposes."⁶

It is to be noted that the result thus achieved is not otherwise obtainable under the Code's like-kind exchange provisions—which permit real estate and other tangible business or investment property to be exchanged for similar property without tax—since these provisions expressly exclude trades in securities.⁷ Moreover, while the tax-free reorganization sections confer a somewhat similar set of benefits in cases involving the acquisition by a publicly-held company of the assets or stock of a smaller closely-held concern,⁸ the latter transaction normally

and sold at prices that relate to "net asset value"—which is determined on a per share basis by taking the market value of the securities in the fund's portfolio, adding the value of other assets and subtracting liabilities, and dividing the result by the number of shares outstanding. See Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181 (1961).

As indicated below, capital exchange funds, though open to share redemptions and hence technically open-end funds, do not engage in continuous public offerings of new shares. See note 45 *infra*.

5. Prior to the predecessor of present section 351, a transfer of property to a corporation in exchange for all of its stock was regarded as a sale, and gain or loss was recognized to the transferor or transferors. Napoleon B. Burge, 4 B.T.A. 732 (1926). Since 1921, when the predecessor section was enacted, no gain or loss has been recognized on such transactions.

6. Prospectus of Centennial Management And Research Corporation 3 (Dec. 23, 1960).

7. I.R.C. § 1031(a).

8. I.R.C. §§ 368, 361 and 354. And see Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254, 257 (1957).

involves the sale of an operating business and is likely to be a once-in-a-lifetime occurrence from the standpoint of the seller. In contrast, the capital exchange fund phenomenon may involve the disposition of securities acquired purely for speculation and can occur as often as the individual is fortunate enough to find himself with substantially appreciated securities on hand and there are new funds available for exchange purposes. Indeed, the opportunity to acquire fund shares now also sometimes serves as the capstone of a prior reorganization exchange since it allows the former owner of the closely-held corporation to complete the tax-free transition from entrepreneur to investor status by obtaining, in exchange for the stock of the acquiring corporation, a fractional interest in a more or less balanced portfolio of high-grade issues.⁹

Exchange funds are, of course, 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.”¹⁰ As a self-help technique, and one that has a strong flavor of “unintended benefit,” the fund arrangement reportedly has been subjected to an intensive, though evidently inconclusive, analysis by the Internal Revenue Service.¹¹ The Service, having initially issued a few favorable rulings on fund formations, subsequently changed its mind (by half) and announced that it would no longer issue any formal rulings with respect to such transactions, either favorable or unfavorable.¹² However, legal opinions have been secured to the effect that section 351 is applicable and these are referred to in the fund prospectuses under the heading “Federal

9. In addition to those who desire to avoid the tax cost of selling low-basis securities for cash, the exchange funds may be of use to persons owning stock the sale of which is restricted by SEC regulations, to corporate employees holding stock acquired through the exercise of employee stock options, or to the officers of a corporation when “it wouldn’t look right for them to be selling the stock of the corporation in which they are corporate officers. . . .” Bierman *et al.*, *Substance vs. Form in Corporate Activities: A Series of Panel Discussions*, N.Y.U. 20TH INST. ON FED. TAX 975, 995 (1962).

10. Prospectus of Centennial Management And Research Corporation 3 (Dec. 23, 1960).

11. See Caplin, *Taxpayer Rulings Policy of the Internal Revenue Service: A Statement of Principles*, N.Y.U. 20TH INST. ON FED. TAX 1, 24 (1962); Bierman *et al.*, *supra* note 9, at 995-96.

12. T.I.R. 303 (Feb. 9, 1961). At about the same time the Service announced that it would issue no rulings with respect to promoter-solicited transfers of appreciated real estate to a newly formed real estate investment trust in exchange for shares or interests in such a trust. T.I.R. 312 (March 13, 1961). And see Rev. Proc. 63-20, 1963-2 C.B. 754, stating that the no-rulings policy would apply equally to transfers of securities to funds organized as partnerships or trusts.

Tax Status,"¹³ although the Service's refusal to rule on fund formations is not there disclosed. It is not entirely clear whether the no-rulings policy simply reflects the closeness of the legal issues raised by the exchange fund arrangement, or is intended to have a deterrent effect on fund promoters and their counsel.¹⁴ If the latter, however, it has miscarried. While the Service will not rule on proposed fund formations at present, the more important fact is that it has not attacked in the case of funds completed without a ruling, so that at least in public contemplation the official attitude towards exchange funds appears as one of tolerance or resignation.¹⁵

But the matter is too important to be resolved by silence and one suspects that the Service may presently feel obliged to begin again to issue favorable rulings on Centennial-type fund formations.¹⁶ Before this occurs, if it does at all, and in any event because the exchange fund device appears to have found a regular place in the tax-planner's tool box,¹⁷ a consideration of the issues seems appropriate.

13. *E.g.*, Prospectus of Second Congress Street Fund, Inc. 4 (Jan. 16, 1964).

14. See Goldman, *Warwick Fund ruling withdrawn; IRS policy questioned*, 19 J. TAXATION 197, 198 (1963), criticizing the Service's no-rulings policy on the ground that "the official purpose in not issuing rulings was, apparently, not based upon any belief that the exchange is taxable; no ruling has ever been issued nor any cogent thesis offered to that effect, so far as is known. On the contrary, the Service, banking on the investor's fear to act without the protection of a ruling, simply denied that protection."

15. Following the issuance in 1961 of T.I.R. 303 (Feb. 9, 1961) note 12 *supra*, some commentators were of the view that the Service's refusal to rule on exchange fund formations had "pretty much killed the idea." Bierman *et al.*, *supra*, note 9, at 997; ISRAELS *et al.*, S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS 102 (1962). Reports of death proved premature, however, as fund prospectuses again began to appear in number towards the end of 1962. Though unblest by ruling, the newer funds were able to furnish unqualifiedly favorable opinions of counsel and had little difficulty in most instances in attracting investor interest on that basis. The only event of a public nature that seems to have occurred in the interim—that is, between the time the idea appeared dead and the time it revived with a rush—was the publication of an unofficial but widely circulated speech by the then Commissioner of Internal Revenue in which, in the course of a general description of Service rulings policy, the Commissioner remarked that the refusal to rule in certain "close" situations, presumably including exchange fund formations, should not be taken to mean that the Service was "necessarily . . . hostile . . . towards the transaction," but only that it did not wish expressly to approve of it. Caplin, *supra*, note 11, at 15; and see Caplin, *A Status Report From the Commissioner*, 14 THE TAX EXECUTIVE 9, 18 (1961). These remarks, together with the Service's failure to attack the first fund formed without a ruling, evidently provided assurance for most investors and their counsel that there was nothing really to be feared. See Note, *Explanation of Commissioner's Comments on Centennial Funds*, 16 J. TAXATION 62 (1962).

16. Precisely this appears to have occurred in the related area of personal holding company mergers. See note 76 *infra*.

17. See Feder, *Relieving the Impact of the Revenue Act of 1964 on "New" Personal Holding Companies*, N.Y.U. 23D INST. ON FED. TAX 723, 742 (1965).

CAPITAL EXCHANGE FUNDS: ORGANIZATION AND TAX STATUS

Since speculation concerning the tax status of exchange fund formations has largely centered upon the formative procedure itself, a brief description of that procedure is required by way of background.¹⁸

An exchange fund is an incorporated entity formed on the basis of a small cash contribution by the fund promoter or by the investment management organization which will assume the duties of portfolio supervision once the fund is underway. The shares of the fund are offered to the public by means of a prospectus filed with the Securities and Exchange Commission and are distributed through securities dealers at a cost to the purchaser of a sales charge which is scaled down as the size of the transaction increases. Fund shares are not, of course, sold to the public for cash. Instead, investors holding appreciated securities acceptable to the fund manager are invited to deposit those securities, together with information relating to their tax bases, with a bank designated as depository pending the completion of the fund.¹⁹

A list of securities deemed acceptable by the fund manager on the basis of their investment quality is included in the fund's prospectus. The fund manager, however, retains the right to accept or reject any security offered for deposit, whether or not it appears on the acceptable list, and all of the funds contain some securities not so listed. On the other hand, it is likely that the volume and variety of the non-listed securities that are offered for deposit is large, and it may be presumed that a substantial number are rejected by the fund manager as unsuitable for investment.

Securities accepted for deposit during the solicitation period are not then exchanged for fund shares but are held by the depository under an escrow agreement, with all voting and dividend rights remaining in the depositor. At the end of the solicitation period, which normally lasts three to four months, deposits are closed and the fund transmits to the depositors a "preliminary report," which lists all securities then on deposit with their tax bases and respective market values. 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

18. The procedure adopted is uniform for all the funds, and with minor modifications follows the pattern set by the Centennial Fund formation.

19. The minimum aggregate value of securities required to be deposited by each investor is usually \$25,000, although the average deposit is apparently often greater. See note 44 *infra*.

depository at any time within a period of three weeks following receipt of the report. For a brief additional period, usually one week, the fund manager may exercise a further right of rejection in order to redress any imbalance in the portfolio resulting from withdrawals based upon the preliminary report. As a consequence of possible withdrawals and rejections occurring after the close of the solicitation period, the securities ultimately exchanged for the shares of the fund may differ somewhat from those contained in the preliminary report, although the difference is usually minor.

Unless withdrawals by depositors and rejections by the fund manager reduce the aggregate market value of securities remaining on deposit below a stated minimum on the day following the close of the final rejection period, the exchange of shares of the fund for the deposited securities is consummated on that day without any further action by the depositors. For purposes of determining how many shares of the stock of the fund shall be issued in the exchange, the securities of each investor are valued as of the exchange date with a deduction for the applicable sales charge.

The exchange funds are technically open-end funds, which means that the fund shares are redeemable at net asset value at the option of the holder. At the same time, as indicated below, the funds are barred from offering new shares to the public once the original offering has been completed and are thus closed to share purchases for cash other than through the reinvestment of cash dividends.

Once operative, the fund will proceed to qualify as a "regulated investment company" under Subchapter M of the Internal Revenue Code by annually distributing to shareholders substantially all of its net dividend and interest income.²⁰ It is then treated as a conduit for income tax purposes and in effect is relieved of liability for corporate tax. Amounts distributed by the fund out of net investment income are, of course, taxed to the shareholders as ordinary dividends. Net long-term capital gains, if distributed currently, are also taxed to the shareholders, rather than the fund, and at long-term capital gain rates.

If, as is commonly the case, the fund elects to retain instead of distributing its realized net long-term gains, such gains are taxed to the fund at a rate of 25%. The fund, however, may treat the accumulated capital gains as if constructively distributed to shareholders, in which event the shareholder is required to include his pro-rata share of such gains in his own income as long-term capital gain.²¹ The 25% capital

20. I.R.C. § 851 *et seq.*

21. I.R.C. § 852(b)(3).

gain tax paid by the company is then treated as having been paid on the shareholder's behalf, and the latter is entitled to credit his share of the total tax paid against his individual tax liability. To prevent a double capital gain tax on the disposition of his fund shares, the shareholder increases his basis for those shares by 75% of the constructive distribution. To illustrate, suppose an investment company has net long-term capital gains for the taxable year of \$4 per share. The company distributes no portion of that gain but designates the entire amount as a capital gain dividend for the year and pays a tax of \$1 per share on its shareholders' behalf. A shareholder holding fund shares with a basis of \$20 would then include \$4 in gross income as long-term capital gain, credit \$1 against his individual tax liability, and increase the basis of his fund shares to \$23.²²

The exchange of individually-owned securities for shares of the fund is, as earlier stated, assumed to be tax free to the individual transferor under section 351. On this assumption, the basis to the corporate transferee of the securities acquired on the exchange is the same as the basis of those securities in the hands of the several transferors,²³ and the basis of the fund shares received by the individuals is the same as the basis of the securities exchanged therefor.²⁴ Gain is thus postponed, not forgiven. When shares are redeemed, the shareholder recognizes a capital gain (or loss) in the amount of the difference between the cash plus the fair market value of any property received and the adjusted basis of the shares surrendered.²⁵

It is worth mentioning, finally, that share redemptions as they occur are normally satisfied by the fund in kind, that is, by distribution of portfolio securities rather than cash to the redeeming shareholder. Distributions in kind do not result in the recognition of gain by the fund;²⁶ cash redemptions, on the other hand, would entail a forced realization of gain by the fund, and would subject the continuing shareholders to a reduction in the net asset value of their shares equal to the tax paid. It may be assumed that the securities used to meet redemption demands are chosen with a view to improving the quality

22. The exchange fund prospectuses state—somewhat cryptically, as it seems—that “since there will undoubtedly be considerable variation in the degree of unrealized appreciation of the assets of the various investors, the pooling of capital gains tax liability on assets which the Fund . . . find[s] it advisable to sell at a gain will be of greater advantage to some investors than to others.” *E.g.*, Prospectus of Second Congress Street Fund, Inc. (Jan. 16, 1964), p. 5.

23. I.R.C. § 362(a).

24. I.R.C. § 358(a).

25. I.R.C. § 1001.

26. I.R.C. § 311(a); Regs. § 1.311-1(a).

of the portfolio and, if consistent therewith, disposing of low-basis assets. This need involve no disadvantage to the redeeming shareholder provided that the securities received by him can at once be converted into cash,²⁷ and in that connection it is understood that some fund management organizations are now extending guarantees to shareholders with respect to the cash convertibility at or near net asset value of any securities distributed to them in redemption of their fund shares.²⁸

PROMOTER SOLICITATION AND THE "CONTROL" REQUIREMENT

The purported application of section 351 to exchange fund formation comes as a surprise, initially at least, to those who share a common, classroom image of the type of transaction that is contemplated by the section. 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.²⁹ By contrast exchange fund formations may involve upwards of a thousand shareholders, each of whom, 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. Moreover, these persons 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 solicitation by promoters, brokers or fund management companies. Since the fund is publicly held the investors lack day-to-day control over management activities and, of course, have no individual management responsibilities. The qualities of group identity and active shareholder participation that are normally anticipated in section 351 transactions are thus necessarily absent in the formation of an exchange fund, as of course they would be in the formation of any public company, at least as respects the public shareholders.

These elements of departure from the more familiar image of a small business incorporation prompt at least a suspicion that the sec-

27. A shareholder receiving a distribution of portfolio securities in redemption of his shares of the fund takes a basis for the securities received equal to their value at time of distribution, I.R.C. § 1012, so that a prompt resale of the securities results in little or no further gain or loss. See BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 242 (1959).

28. Reported in *Fortune*, May, 1965, p. 64.

29. For a discussion of some of the tax and corporate problems incident to the incorporation of a small enterprise, see *Hervitz, Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 *HARV. L. REV.* 1098 (1962).

tion has been put to an unintended (certainly an unexpected) use. The suspicion grows stronger by reason of the circumstantial resemblance between fund formations and what former Commissioner Caplin has called an ordinary "marketplace exchange of securities."³⁰ Thus the exchange of individually-owned securities for shares of the fund has the same anonymous and impersonal quality as an ordinary brokerage transaction; it is effected through a securities dealer; it involves the payment of a sales commission; and it eventuates in nothing less than the exchange of one marketable security for a claim upon others. The individual investor doubtless has the same sense of having gone through a sale-and-reinvestment process that he has in a conventional trading situation and is presumably indifferent (other than from a tax standpoint) to the omission of a cash step along the way.

In issuing its "no-rulings" release in 1961, the Service took care to confine and direct itself to transactions involving an exchange of appreciated securities for shares in a newly organized investment company which occur "as a result of solicitation by promoters, brokers or investment houses."³¹ The technical justification for this position has never been stated officially, but it is evident from the stress on "solicitation by promoters" that the Service shares the supposition that section 351 is intended to apply to corporate formations by persons who together have some element of identity or prior association. The difficulty, no doubt, has been to find anything in the statute that will turn that supposition into a supportable limitation on the scope of the section.

It has been reported that the Service initially entertained doubts as to whether exchange fund formations meet the "control" requirement of section 351(a).³² Section 351 requires that the persons transferring property to a corporation be in "control" of it "immediately after the exchange," "control" being defined as ownership of at least 80% of the corporation's outstanding shares.³³ The 80% requirement may be met by the transferors as a group even though no single shareholder in the group owns that percentage, but it is obvious that the several persons transferring property must be seen to have acted in concert in order to permit their shares to be aggregated. What evidently matters—at least where time-relatedness is in doubt—is that the transferors obtain control of the corporation by virtue of a prearrangement which defines

30. Caplin, *supra* note 11, at 23.

31. T.I.R. 303 (Feb. 9, 1961).

32. Bierman *et al.*, *supra* note 9, at 996.

33. I.R.C. §§ 351(a) and 368(c).

their rights as stock or security holders and expresses their intention to act concertedly.³⁴

When, as in the case of the exchange funds, properties are simultaneously exchanged for shares of the corporate transferee by persons who, as a consequence, obtain more than 80% stock ownership, it is hard to deny that there has been compliance with the "control" test, even if it be said that the simultaneity of the exchange reflects no more than a shared intention to act so as to meet the test itself. What would have to be shown—and what the Service apparently finds it impossible to show—is that simultaneity is lacking in substance, though formally attained. Such a showing would apparently require a determination that the individual deposits of securities in escrow, which take place over a period of months and hence at least are non-simultaneous, are in fact equivalent to an outright exchange of property for fund shares. In effect, the argument would be that the fund, having been formed initially by 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. Looked at in this way, each depositor (with the possible exception of the very earliest depositors) could be said to have exchanged his securities for a non-controlling interest in the fund, and hence to have made a taxable exchange.³⁵

But this contention, if pressed, would not be difficult to answer. In the first place, beneficial ownership of the deposited securities remains in the individual depositors until the exchange date, each depositor having the right to vote his securities and receive cash dividends, and each obtaining credit for (or being charged with) any change in the value of his securities while in the hands of the depository. The Service has ruled that the ownership of escrowed securities attaches to the party who possesses the voting and dividend rights, even though that persons lacks a present right to obtain the property from the escrowee.³⁶ The fund depositors, in addition to voting and dividend rights, retain an absolute right to withdraw their securities from the depository and are in no way bound to make the exchange until the end of the withdrawal period. These factors, particularly the withdrawal right, provide an answer, and probably a complete answer, to

34. Regs. § 1.351-1(a)(1).

35. Regs. § 1.351-1(a)(2), *Example 2*.

36. Rev. Rul. 55-458, 1955-2 CUM. BULL. 579; and see *McAbce v. Commissioner*, 5 T.C. 1130 (1946) (acq. 1946-2 CUM. BULL. 4).

any argument that the initial deposit of securities by the investor constitutes a final disposition of those securities.³⁷

Viewed somewhat less mechanically, it is likely, if not certain, that each investor would wish to form some judgment with respect to the investment merits of the fund's portfolio before committing himself irrevocably to make the exchange. The "preliminary report" gives the depositor an opportunity to compare his own prospective contribution with those proposed to be made by others, and he may withdraw if he determines that the composition of the fund is undesirable. Quite obviously, the withdrawal period must end simultaneously for all the depositors, so that the simultaneity of the exchange, far from being a tax contrivance, can be said to be necessary and unavoidable in the formation of an exchange fund. To put the same point affirmatively, if the investor elects to remain in the fund, it is presumably because he finds the portfolio satisfactory and expects the other depositors, or most of them, to do likewise. It is true that others may withdraw without his knowledge and that the final portfolio may therefore differ from that contained in the "preliminary report"; but since a succession of preliminary reports would be impractical, this is a risk he is obliged to accept in order to avoid unduly delaying the completion of the fund. At all events, to find that the several transfers lacked mutuality or interdependence, one would have to assume that every investor had been prepared to conclude that any combination of securities acceptable to the fund manager would out-perform his own. But such an assumption seems unlikely, or at any rate unprovable. Moreover, there are always some (though admittedly few) withdrawals following submission of the preliminary report; hence the right to withdraw cannot be regarded as meaningless or insubstantial.

Accordingly, if the Service, by placing stress on the factor of promoter solicitation, means (or, at the time it issued the no-rulings release, meant) to suggest that the formative procedure really involves a series of disconnected transactions with the fund, the short answer is that there are no completed transfers prior to the exchange date. In addition, since contributions to the fund follow a period of mutual inspection and appraisal, it can hardly be said that the depositors act wholly independently of one another in acquiring "control" of the entity. It is true that concerted behavior on the part of the transferors is the consequence of promoter activity rather than investor initiative,

37. See *Lucas v. North Texas Lumber Co.*, 281 U.S. 11 (1930); *Commissioner v. Segall*, 114 F.2d 706 (6th Cir. 1940).

but presumably this has relevance only if section 351 can be said to be limited to small business formations and to exclude public issues. Nothing in the language of the section points to such a limitation, however, nor does it appear that the Service has previously attempted to confine the application of the section to closely-held situations.³⁸ The requirement of "control" thus serves poorly as a means of preventing the widescale pooling of investment property under section 351, and if this is the best technical objection that can be offered, it is not difficult to understand why the Service has been unwilling to declare itself in open opposition to the funds.

TAX POOLING AND TAX POSTPONEMENT

What may not be entirely clear, on the other hand, is whether an analysis of the tax issues relating to the applicability of section 351 is necessarily exhausted with the concession that the "control" requirement is met by virtue of the simultaneity of the exchange. There is, in Subchapter C, no scarcity of precedent for the view that the foreseeable outcome of a particular arrangement purporting to qualify for tax-free treatment has bearing on its tax status,³⁹ and for this reason one's attention is drawn to the way in which the funds are carried on once the organizational procedure has been concluded. At the least, a picture of the exchange fund as an investment medium is incomplete without a description of its operating characteristics, both as they exist and as they are represented to and contemplated by the depositors. What, for example, is the effect upon the conduct of the fund's business of the investor's well-emphasized objective to postpone tax? And how does the pooling of individual tax liabilities affect the relationship between the fund and its shareholders?

It is important to remember that the formation of an exchange fund, if it qualifies as tax-free, involves not only a pooling of individually-

38. Thus, what is the effect under section 351 where the owners of appreciated property contribute their assets to a newly formed corporation in exchange for stock and simultaneously therewith the corporation makes a public offering of its shares? The Service, as far as is known, does not challenge the applicability of section 351 to the transfer of the non-cash assets, even though the deal may be the dream-child of a promoter, and, indeed, even though, as a consequence of the public offering, the non-cash transferors will emerge with less than 80% of the corporation's stock. See *American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948).

39. See, e.g., *Commissioner v. Ashland Oil and Refining Co.*, 99 F.2d 588 (6th Cir. 1938), *cert. denied*, 306 U.S. 661; *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951); *S. Klein On the Square, Inc. v. Commissioner*, 188 F.2d 127 (2d Cir. 1951); *Rosenberg's Estate v. Commissioner*, 36 T.C. 716 (1961); *Grubbs v. Commissioner*, 39 T.C. 42 (1962).

owned securities but also a pooling of individual tax-potential by reason of the carryover of individual tax bases.⁴⁰ Assuming the original exchange is not taxable, the fund's portfolio will thus initially consist exclusively of low-basis, high-value securities. For most funds, the bases of securities exchanged by the individual investors for shares of the fund average 10%-15% of the value of those securities at the exchange date, and in consequence the assets of the fund are encumbered (or are presumed to be encumbered) by a potential capital gains tax liability which at the formation of the fund may run above 20%⁴¹ of the value of the total portfolio. The carryover of individual tax bases and the magnitude of the accumulated tax potential that results (again presumed) represent the principal distinguishing features of the capital exchange fund as compared with conventional mutual funds, and these features have implications for the structure and operations of the exchange funds which merit discussion.

Concerning the structure of the funds, it has been noted that the funds are open-end with respect to share redemptions, but closed-end with respect to share purchases. As in the case of conventional open-end funds, the exchange funds stand ready at all times to redeem their outstanding shares at net asset value. With limited exceptions,⁴² however, no new shares can be issued by the funds and no new investor capital can be attracted. Unlike conventional investment companies, which are either open at both ends or closed at both ends, the stated capital of the exchange funds can only decline as redemptions occur. Since this prospect is undoubtedly a matter of considerable regret to the fund manager, whose fee is computed as a percentage of net assets, there must be a compelling reason for the closed-in, open-out structure of the exchange funds.

Essentially, the structure of the exchange funds reflects the necessity of excluding outsiders from participation in the fund. To put it otherwise, the peculiar open-and-closed arrangement is designed to protect investor net worth against the probability—apparently regarded as overwhelming—that the shares of the fund, if issued for cash or sold in the public market, would have to be issued or sold at a discount from net asset value.

40. I.R.C. § 362(a).

41. *I.e.*, 25% of 85%-90%.

42. The exceptions are of two kinds. First, at the shareholder's option, dividends from net investment income may be paid in additional shares of the fund instead of cash. Second, the funds may acquire the assets of private investment companies in exchange for fund shares in tax-free mergers. As to the latter type of transaction, see notes 43 and 76 *infra*.

Such a discount factor is probable because the assets of the exchange fund are from the outset encumbered by an exceedingly large contingent tax liability. Sale by the fund of all or a portion of the original portfolio will necessarily result in the accrual of taxes previously postponed, and hence in a reduction to that extent of the net asset value of outstanding shares. An incoming purchaser for cash, whether contemplating the purchase of outstanding or newly issued fund shares, would presumably be obliged to take that factor into account, that is, to consider the effect of prospective tax accruals on the value of his investment. As a consequence, unless he were prepared to pay an offsetting premium for the services of management in supervising the portfolio, such a purchaser would be expected to be unwilling to acquire fund shares at a price equal to net asset value, and instead to offer something less.

To illustrate the point, suppose the net asset value of outstanding shares is \$100 per share, of which \$80 reflects unrealized appreciation in the securities held by the fund. Assuming no change in the market value of portfolio securities, the sale by the fund, over a period of time, of the entire original portfolio would result in the realization by the fund of \$80 per share of capital gains. The fund would make tax payments over the same period of \$20 per share on behalf of its shareholders (25% of \$80), and there would be an increase in the basis of outstanding shares of \$60 per share (75% of \$80). Assuming no change in the market value of the securities into which the proceeds of sale were reinvested, the net asset value of fund shares after all original securities had been sold would be reduced from \$100 to \$80 (\$100, original net asset value, minus \$20, taxes paid).

An outsider who purchased fund shares for cash at \$100 per share at the beginning of the period would thus find that a portion of his investment had been converted into tax payments by the end of the period. The basis of his shares, it is true, would have been increased to \$160 per share (\$100, original cost, plus \$60, addition to basis), and a sale of those shares at a price equal to net asset value at that time would produce a capital loss of \$80 per share (\$160, adjusted basis, minus \$80, proceeds of sale), such loss being equivalent to the capital gains previously recognized. But the prospect of trading hard cash for a capital loss of restricted usefulness, the realization of which would at all events necessitate his ceasing to participate in the fund, is presumably unappealing. Once again, therefore, unless management exerts an offsetting attraction in his estimation, the prospective cash purchaser, on perceiving that the fund contains a large accumulated tax

potential, would be expected to bid less than net asset value for the shares of the fund.

If, disregarding the management factor, it can be assumed that fund shares would sell at a discount in the public market, the need for a redemption privilege on the part of the original fund shareholders becomes apparent. An original fund shareholder having a basis of \$20 for his fund shares and electing to redeem at a time when the net asset value of fund shares is \$100 would have an after-tax recovery of \$80 per share: \$100 less tax of \$20 (25% of the \$80 gain). If the shares were non-redeemable, and if the market price—reflecting a discount of, say, 12.5%⁴³ of unrealized portfolio appreciation, or \$10—were \$90, the seller's after-tax recovery would be only \$72.50: \$90 less tax of \$17.50 (25% of the \$70 gain). The difference in net amount realized of \$7.50 per share (or \$7,500 on an investment of \$100,000, reported to have been the average shareholder investment in one exchange fund⁴⁴) results because the selling shareholder picks up in addition to his own tax a portion of the prospective tax obligation assumed by the purchaser. Accordingly, the exchange funds are obliged to include an optional share redemption feature in order to avoid the prospect of an immediate decline in the value of fund shares, a decline which would tend to approximate the amount of the potential capital gains

43. The merger of a personal holding or private investment company owning substantially appreciated securities into a conventional mutual fund whose portfolio shows a lesser degree of appreciation normally requires a compensating reduction in the exchange value of the private company's assets. On the assumption that the merger qualifies as a tax-free reorganization (see note 76 *infra*), the basis of the assets acquired by the fund will be the same as the basis of those assets in the hands of the private company. To the extent that the element of unrealized appreciation in the assets acquired exceeds the element of unrealized appreciation in the fund's portfolio at the time of the merger, a net contingent tax liability is passed on to the present and future shareholders of the fund, which will accrue as and when the acquired securities are sold. To adjust for this disparity, under SEC practice a discount of 12.5% of the excess of the percentage of appreciation of the private portfolio over that of the fund portfolio is applied to the value of the acquired assets; the resulting figure then becomes the exchange price and governs the number of fund shares to be received by the shareholders of the private company on the exchange. The 12.5% figure is simply the midpoint between zero and the maximum capital gains tax rate of 25%. See, e.g., Fundamental Investors, Inc., SEC Inv. Co. Act Release No. 3952 (1964); Broad Street Investing Corp., SEC Inv. Co. Act Release No. 3884 (1964).

In the light of this discount procedure, the capital exchange funds would appear to be better situated for merger with private investment companies than conventional mutual funds. Since the element of unrealized appreciation in the exchange fund's portfolio is likely to equal or exceed that of the private company, no discounting of the exchange value of the private company's assets would be required. But despite this advantage, the exchange funds seem to have attracted relatively little merger business so far.

44. Business Week, April 24, 1965, p. 148.

tax to a purchaser for cash, reduced by any premium that such a purchaser would be willing to pay for management.

Moving to the share purchase side, the Securities and Exchange Commission is evidently unwilling to assume that the value of management services can ever entirely offset the fund's inherent tax encumbrance, since the Commission has required the exchange funds to agree not to engage in any future offering of their shares to the public, either on a continuous basis or at intervals.⁴⁵ Although it is difficult to believe that such a safeguard is really needed (or warranted), quite obviously the prohibition is intended to protect unsuspecting buyers from acquiring a share in the fund's tax potential at full cost. A continuous (or occasional) offering of shares for cash at a discount, moreover, if feasible, would be unacceptable to the original shareholders since the effect would be to dilute the net asset value of the shares issued to them on the original exchange and thus in effect to actualize a portion of their tax.⁴⁶

A similar set of observations is to be made about the relationship that exists among the fund shareholders themselves. It may be supposed that many and indeed most fund shareholders will cease to enjoy an individual benefit from tax-deferral well before the accumulated tax potential in the fund has disappeared. This is obviously true with respect to those fund shareholders who, preferring other investment opportunities to the advantage of tax-deferral, elect to redeem their shares in a taxable transaction. But it is also likely to be true of a substantial number of the fund shareholders who choose to stay with the fund and avoid a taxable redemption. Owing to adjustments in the bases of their shares, occurring either by reason of portfolio turnover at the fund level or by reason of the death of the shareholder himself, investors in the second group (or their estates) will ultimately hold their fund shares at a tax basis equal to or approximating the net asset value of those shares. Thus the certain effect of death, or alternatively the long run effect of portfolio turnover, is to put the continuing shareholder (or his estate) in the position of having made a fully tax-paid

45. See, *e.g.*, Congress Street Fund, SEC Inv. Co. Act Release No. 3118 (Oct., 1960); Federal Street Fund, Inc., SEC Inv. Co. Act Release No. 3206 (March 2, 1961); Ohio Franklin Fund, Inc., SEC Inv. Co. Act Release No. 3247 (May 11, 1961).

46. Thus, where the promoters of a newly formed mutual fund provide its initial capitalization by contributing their own appreciated securities, under SEC practice the net asset value of fund shares, for purposes of determining the public offering price of such shares to cash purchasers, is computed by setting aside a reserve for future capital gains tax equal to 12.5% of the unrealized appreciation in the promoters' contributed securities. See, *e.g.*, Invest Fund, Inc., SEC Inv. Co. Act Release No. 3292 (July 18, 1961).

investment in the fund at a price equal to net asset value, just as if the shares were then purchased at net asset value for cash. The important point is that this position will often be attained at a time when the fund itself is still encumbered by a more or less substantial accumulated tax factor.

With respect to portfolio turnover, it is to be noted that while none of the shareholders acquires his original shares for cash, all contributing appreciated property, there evidently is a considerable range of basis-to-value ratios among the shareholders at the time the fund is formed.⁴⁷ To the extent that original portfolio items are traded out of the portfolio, a capital gains tax accrues to the fund reducing net assets, and the tax basis of the fund shares in the hands of the individual investor is adjusted upwards by 75% of his share of the gain recognized.⁴⁸ As this process goes forward year by year, however slowly, those shareholders whose individual bases are at (or reach) the higher end of the range will find that their own need or opportunity for tax deferral has disappeared, although the fund itself continues to hold a portfolio of appreciated securities.

In the other alternative, the death of the shareholder will have the same effect. If fund activity were wholly lacking, or if (whatever the pace of fund activity) the particular shareholder is still in a position to benefit from tax-deferral at the time death occurs, then at death, as the law stands,⁴⁹ the basis of the decedent's shares will be increased to equal their net asset value. Again, however, fund assets would still be expected to show a measure of unrealized appreciation in many cases.

Whether through portfolio activity or death, therefore, the continuing fund shareholder (or his executor) is likely to find himself in the position of having made (by force of circumstance) the very commitment which a purchaser for cash is presumed to be unwilling to

47. The funds' initial reports to investors—which contain a list of all securities to be exchanged for fund shares, including for each security its value and tax basis—show that the bases of the various securities to be exchanged range from zero to 60% of market value. While it cannot be ascertained from the reports whether a given investor has transferred more than one security, or whether the funds' holdings of a particular security are derived from more than one investor, it seems reasonable to assume—for example, in the case of zero-basis securities having substantial value—that at least some securities are received from a single investor and represent his entire contribution. In any event, as noted, the fund prospectuses specifically state that “there will undoubtedly be considerable variation in the degree of unrealized appreciation of the assets of the various investors. . . .” Prospectus of Second Congress Street Fund, Inc. 5 (Jan. 16, 1964).

48. See note 20 *supra*. I.R.C. § 852 (b)(3)(D)(iii).

49. I.R.C. § 1014(a), providing that the basis of property in the hands of a person acquiring the property from a decedent shall be the value of the property at the date of the decedent's death (or its value at the alternate estate tax valuation date).

make in the first instance, *i.e.*, the "acquisition" of fund shares at a cost equal to net asset value despite a substantial accumulated tax potential in the fund. This position is necessarily disadvantageous, if not untenable. On the assumption that management is not then likely to command a premium, it appears that once the shareholder's own individual tax potential has been actualized through the realization of gains at the fund level, or has been forgiven by reason of death, he or his heirs will be strongly prompted to draw down the net asset value of his shares by presenting those shares for redemption. If the shareholder retains his shares, and the balance of the fund's tax potential subsequently accrues, a portion of the shareholder's investment will be converted into tax payments accompanied by a further adjustment in the basis of his shares. Again, unless he is prepared to pay a premium for management, the shareholder whose tax-deferral needs have been relieved by events would be expected to find the latter prospect unacceptable.

Assume, for example, that A, B and C pool their securities in a fund. Each security has a value of \$100, but A's basis is zero, B's basis is \$30, and C's basis is \$60, for the security transferred. The fund thus receives property having an aggregate value of \$300 of which \$210 is unrealized appreciation (\$300 minus the sum of 0, \$30 and \$60). The basis of A, B and C for their fund shares is the same as the basis of the securities exchanged therefore, *i.e.*, 0, \$30 and \$60 respectively. Assume the fund realizes gains of \$120 during a given period of one or more years. The fund pays a total tax on such gains of \$30 (25% of \$120), or \$10 on behalf of each shareholder, which payment reduces the value of fund assets to \$270 and the net asset value of each shareholder's interest to \$90. At the same time the basis of all fund shares is increased by \$90 (75% of \$120) or \$30 for each of the three shareholders.

C, who began with a basis of \$60 for his fund shares, now has a basis of \$90, which is also equal to the net asset value of the shares as reduced by tax payments. The fund's portfolio, however, still contains \$90 of unrealized appreciation. Since his own opportunity for tax-deferral has come to an end, C will presumably elect to redeem his shares at this point, unless management is highly valued. If C does redeem, then B, whose basis has been increased from \$30 to \$60, will be in the position that C previously occupied once the fund has realized further gains of \$60.⁵⁰ And if any of the shareholders, including A, should die prior to a

50. Thus, on redeeming C's shares for \$90, the value of fund assets is reduced to \$180 (\$270 minus \$90). Realization of an additional \$60 of gain by the fund results in a tax of \$15 (25% of \$60). The value of fund assets is reduced thereby to \$165 (\$180 minus \$15),

complete turnover of the fund's portfolio, the decedent's estate would then occupy a like status, *i.e.*, the fund shares received from the decedent would have a basis equal to their net asset value, although the fund itself retained a substantial accumulated tax potential. In each case, unless he anticipates an offsetting benefit from the services of management, the shareholder would be expected to redeem his shares promptly because of the prospect of further accruals of tax.⁵¹

Turning next to the operating characteristics of the funds, a striking though readily anticipated consequence of the exchange fund arrangement is the comparatively low rate of portfolio turnover which is uniformly characteristic of the funds. According to a report in *Fortune Magazine*, "The average mutual fund has annually turned over about a sixth of its portfolio in recent years, the average swap fund only about a sixteenth."⁵² Actually, the difference appears to be even greater in most instances. Thus the rate of portfolio turnover may be approximated by relating the value of portfolio transactions for the year (purchases plus sales, divided in half to avoid double counting) to the

and the net asset value of each remaining shareholder's interest is reduced to \$82.50. B's basis for his fund shares, which had been \$60, is increased to \$82.50 by addition of 75% of his share of the fund's realized gain (\$60, basis, plus one-half of 75% of the \$60 gain), although the fund's portfolio then still contains \$30 of unrealized appreciation.

The example, being for illustrative purposes only, assumes that C received cash on redemption of his fund shares. The effect as to B admittedly would be altered if C instead received a distribution of low-basis portfolio securities. See text at note 24 *supra*. Where there is a large number of shareholders, however, while those at the lower end of the range may find their opportunities for tax-deferral enhanced by a combination of sales and distributions in kind to those at the higher end, a substantial number of investors who continue with the fund can nevertheless be expected to be in C's position in time. Moreover, as stated, the effect of death on the basis of fund shares is independent of portfolio turnover.

51. It is true that section 1014, under which the basis of property acquired from a decedent is adjusted to equal its value at the decedent's death, is a tax rule and not an immutable economic circumstance. But tax rules—*e.g.*, the non-taxability of unrealized gains and losses as opposed to their recognition if the property is sold—are presumably a vital aspect of the total environment in which a transaction arises, as the exchange fund device well illustrates. See also *Knetsch v. U.S.*, 364 U.S. 361 (1960). Moreover, in view of recent unsuccessful efforts to modify section 1014, it appears that any significant change in the death-basis rule is exceedingly remote. See S. REP. NO. 830, 88th Cong., 2d Sess. 161 (1964). At all events, the analysis in the text would be affected only if the section were altered to provide for a carryover of the decedent's basis to his heirs; there would be no effect if, as the Treasury proposed in 1962, death were treated as an occasion for the realization of capital gains. If, as some have said, the "locked-in" syndrome largely depends on the existence of a rule which wholly forgives tax at death, see *Holt & Shelton, supra* note 2, at 352, then not only would the substitution of a carryover basis rule affect the analysis of existing exchange funds, but the further proliferation of such funds would come to a halt and the entire problem would lose importance.

52. *Fortune*, May, 1965, p. 64.

average value of assets held by the fund during the same period. One would exclude the value of securities distributed in redemption and sold to pay dealers' fees, since these transactions obviously create no reinvestment opportunities for the fund. On this basis, for fiscal years ending in 1964, the average portfolio turnover rate for all funds having assets in excess of \$20 million was less than 3.5%.⁵³ (It may be noted that although the exchange funds engage in much less portfolio activity than conventional funds, they do not, and in prudence cannot, avoid sale-and-reinvestment activity altogether. In addition, since the securities that are sold from time to time are substantially appreciated securities, the proportion of such sales constituting realized capital gain is necessarily very high.⁵⁴)

To some extent the difference in rate of turnover between conventional funds and exchange funds is attributable to the fact that the latter accept a limited quantity of "hot" stock—control stock and stock held under an investment representation—which cannot readily be disposed of by reason of restrictions arising under the Securities Act.⁵⁵ In even greater measure, however, the low turnover rate of the exchange funds is explained by the very purpose for which the funds are formed, namely, to permit the locked-in investor to improve his market position without the recognition of capital gain. This purpose is not exhausted by the tax-free formation of the funds. Indeed, that is merely the beginning. The funds, by their own advertisement, are intended to appeal to investors "who feel *prevented* from diversifying because of what they consider to be the *excessive* tax cost of selling appreciated

53. A higher turnover rate obtained in the case of two smaller funds—Centennial Fund and Second Centennial Fund—having assets under \$20 million.

54. Thus, for example, Westminster Fund sold \$3.7 million worth of securities during its fiscal year ended June 30, 1963. Of this amount, \$3 million represented realized capital gain, and the tax payable on behalf of shareholders was \$750,000, or slightly more than 20% of total sales. Annual Report of Westminster Fund, Inc. 11-12 (June 30, 1963).

55. By agreement with the SEC, the exchange funds limit the percentage of restricted stock in the initial portfolio to 15% of the total portfolio; see Prospectus of Presidential Exchange Fund, Inc. 2 (April 19, 1965). Since the funds are open to share redemptions, a larger proportion of restricted stock in the portfolio would presumably create a risk that such stock would be sold to the public (or redistributed, but not necessarily to the original contributor) if redemption demands grew heavy. It has reported that some *closed-end* funds have recently been formed solely or largely for the purpose of acquiring restricted stock, the intent being to open the fund after waiting for a period of time which, it is thought, will satisfy the original investment representation. See Hill, Jr., *Rule 154 Under the Securities Act of 1933 and Related Problems—A Proposed Solution*, 20 Bus. Law 335, 341 (1965). And see Registered Exchange Fund, Inc., SEC Inv. Co. Act Release No. 4232 (April 29, 1965).

assets.”⁵⁶ It can hardly be doubted, therefore, that a large proportion of the investors who go into the exchange funds do so as an alternative to the *continued holding* of their original securities.

The assumption must be that were the funds to engage in portfolio activity at what is evidently a normal rate for investment companies of equal size, they would as to many and perhaps most investors become tax-precipitation rather than tax-postponement devices and substantially lose their attraction. Even for those investors who otherwise planned an immediate taxable sale of their securities, the accrual of a major portion of the fund's tax potential within, say, a 5 to 10 year period would render the value of the tax-deferral privilege marginal. And for those investors having a higher-than-average basis for their contributed securities, the prospect of being forced out of the fund, as it were, at a relatively early date would make it inadvisable to pay the dealer's commission that is assessed at the inception of the fund.

Far from hastening the recognition of gain through ordinary management activity, however, the exchange funds are expected to permit those investors who would in any case have retained their original securities beyond the fund formation date—and no doubt many wealthy investors are estate oriented—to postpone the moment of taxable realization for a period at least as long as might have been foreseen with respect to those original securities, but to do so while enjoying the benefits of diversification. The primary exercise of managerial judgment is in the selection and rejection of securities originally offered for exchange, and is thus supposed to have occurred before the fund is formed. The better that judgment has been, the more the shareholders will have succeeded in achieving their postponement objectives. To the extent that the fund manager is actually required to “manage” after the fund is formed (other than by selecting securities for distribution in redemption), the purpose of the arrangement is, strictly speaking, frustrated. Although some management activity is obviously unavoidable, it may be supposed that many fund shareholders are amply supplied with investment counsel from other sources and have no pressing need for additional advisory services; the exchange funds are not (or are not yet) for the small investor.⁵⁷

56. Prospectus of Centennial Management And Research Corporation 3 (Dec. 23, 1960) (Emphasis added).

57. See *Business Week*, April 24, 1965, p. 148. The implication of the low rate of portfolio turnover from the standpoint of the Treasury is that no appreciable anticipation of taxable gain results from the displacement of individual decision-making by profes-

An additional and related aspect of the exchange fund's operating pattern also deserves brief comment. Not only is the rate of portfolio turnover comparatively low, but the value of securities sold by the funds is in most instances exceeded, and in some substantially exceeded, by the value of securities annually distributed in redemption of outstanding shares.⁵⁸ This is true, moreover, even though redemptions are presumably at their lowest level in the early years of the fund. On the whole, therefore, and with few exceptions, the exchange funds are chiefly in the share repurchase business, if "business" for this purpose is measured and defined by comparing the value of securities disposed of through sale with that of securities distributed in redemption.

This observable relationship between portfolio activity and redemptions is consistent with the premise that the fund's aim, within the limits of prudence, is to avoid precipitating the individual shareholder's tax liability. Thus the occasion for taxable realization of gain is primarily intended to be selected by the investor himself, in the light of his own tax and investment needs, and is only secondarily a matter for the judgment of the fund manager.

The exchange funds thus present a total operating picture that is odd by conventional standards, although the picture becomes less strange when one takes account of what the funds are really all about. The fact that portfolio activity is comparatively low, and that it is frequently secondary to redemption activity, suggests, or confirms, that fund management is concerned more with the fulfillment of shareholder tax-postponement objectives than with the ordinary conduct of an investment management service. It has, of course, not escaped notice that the performance record of the exchange funds as a group is poor compared to that of conventional funds, even when the comparison is between exchange funds and conventional funds which are

sional management. Fund shareholders who elect to redeem their shares in a taxable transaction would presumably have switched out of their original investments at or prior to redemption anyway. And the "imposition" of gains tax on continuing shareholders is at so slow a pace that any difference between it and what the shareholders would be likely to have imposed upon themselves may well be inconsequential.

58. Thus, for example, Diversification Fund sold \$864,000 of securities, and distributed securities having a value of \$3,908,000 in redemption of outstanding shares, during its fiscal year ended May 31, 1964. Annual Report of Diversification Fund, Inc., f/y/c May 31, 1964, p. 10. Devonshire Street Fund received \$734,000 as proceeds from sales of securities during its fiscal year ended March 31, 1964, and redeemed fund shares with an aggregate value of \$3,009,000 in the same period. Annual Report of Devonshire Street Fund, Inc., f/y/c March 31, 1964, p. 7. Most of the other exchange funds have followed a similar pattern.

managed by the same investment management organization.⁵⁹ Of course, comparisons of this sort are in a sense incomplete if they fail to take into account the initial reduction in net worth which the exchange fund investor would have sustained had he sold his appreciated securities and invested the after-tax proceeds in the shares of a conventional fund. Obviously the proper comparison from the investors' standpoint is between the results obtained by the exchange funds and the results obtained through "normal" management activity on an initial capital investment reduced by tax.

These observations about the role of exchange fund management have bearing, inferentially at least, on the question whether an investor whose individual tax-deferral needs have been relieved might nevertheless be inclined to retain those shares by reason of a favorable evaluation of management. As suggested, the existence at such time of a substantial tax potential in the portfolio would be expected to prompt the shareholder to redeem his shares in order to avoid the build-up of a capital loss potential, unless the other variable—management—commands an offsetting premium in his estimation. But since fund management is obliged, by the advertised goals of the fund device itself, to be much less than normally active in seeking to enhance the value of fund shares, the evaluation of management is hardly likely to outweigh the tax encumbrance factor and indeed is much more likely to provide an additional incentive to redemption.

To state the same point in another way, the exchange funds lack true continuity as investment media (although this is obviously of little concern to the particular investor seeking the temporary protection of a diversified portfolio). The duration of the tax-deferral period for the several fund shareholders is necessarily uneven, either because the amounts of tax deferred were unequal at the time the fund was formed or because death will end the individual's need for further tax deferral. Hence a good many and perhaps most fund shareholders (who have not previously redeemed their shares in a taxable transaction) are

59. "Four of the eight swap funds that have been in existence since September 1, 1961, had higher asset values per share on that date than on March 31, 1965. The best of the eight, the Diversification Fund, increased by 18% over the period. The Dow-Jones industrial average, meanwhile, increased by 30% (both figures include dividends)." *Fortune*, May, 1965, p. 64. For a similar view, see *Forbes*, Jan. 1, 1965, p. 136, stating also that although it "is far too early to tell, . . . it may be that formations of swap funds correspond for psychological reasons with bull market tops" at 137. A dissenting opinion—based, however, on a performance analysis which *begins* shortly after the May, 1962 market break—appears in *Business Week*, April 24, 1965, p. 148.

likely to find themselves obliged to consider the fund on its merits as an investment medium at a time when the fund is still expected to provide deferral benefits for other shareholders who had lower individual bases to start with or who are longer-lived. The investment merits of the fund, at that time, depend on two variables, accumulated tax potential and management. Tax potential is always a discount factor and may be expected to prompt redemption unless offset by a favorable evaluation of management. But since the purpose of management, once the fund is formed, is to permit investors' capital to "fructify" by avoiding the precipitation of tax, and since this purpose results in a comparatively passive management policy, the evaluation of management services is likely to be negative as well. With both variables negative, the investor has strong reason to terminate his interest by redemption. In consequence, the role of the fund is ultimately that of an agency for the redistribution of property among the members of the original transferor group (or their estates).

Whether inference and prediction at this level will support a legal argument is, admittedly, uncertain. One is tempted to suggest, however, that a challenge to the applicability of section 351 might be made with some chance of success if the operating and redemption pattern of the funds could be said to be foreseeable at the time the funds are formed. Thus one may concede the broadest application for the section—that it applies to the formation of a corporation, including an investment company, by any number of unrelated persons and for any purpose whatever (indeed without articulation of a purpose)—and still assert that it does not extend to the formation of an entity whose principal and intended function is to redistribute the assets transferred to it among the several transferors.⁶⁰ Presumably the section does not exist

60. While the problem is admittedly unusual, the decision of the Board of Tax Appeals in *W. & K. Holding Corp. v. Commissioner*, 38 B.T.A. 830 (1938), at least raises the issue. The controlling shareholders of the taxpayer-corporation transferred to it, in exchange for callable preferred stock, certain securities having a market value substantially below cost. The taxpayer was expected to realize a large gain from the sale of real estate during the taxable year and it was intended to create an offsetting loss by having the taxpayer sell the securities in the same period. The taxpayer did sell the securities and in a subsequent period distributed most of the proceeds to the shareholders by calling their preferred. The taxpayer and the shareholders both claimed deductible losses, the taxpayer on the sale of the securities, the shareholders on redemption of their stock. The Commissioner, contending that the transfer of the securities to the taxpayer lacked a business purpose other than tax-minimization, treated the original exchange as a closed transaction and disallowed both losses on the ground that the basis of the securities in the taxpayer's hands and of the preferred stock in the shareholders' hands was equal to the value of the securities at the date of the exchange. It is to be noted that the Commissioner did not argue that the transfer of securities should be disregarded as fictitious,

in order to postpone tax for its own sake, but contemplates an asset-ownership readjustment in which the corporate transferee obtains the same permanent rights in the property transferred as those which the transferors possessed previously. If, however, the transferors intend that the assets transferred shall subsequently be redistributed among them (whether or not in original form⁶¹), and if redistribution is foreseen in definite terms at the time of transfer, arguably the arrangement is not an asset-ownership readjustment at all but in effect accomplishes an exchange of property among the shareholders themselves. Theoretically at least, the time-gap between the original exchange and the subsequent receipt of the proceeds thereof is merely one bit of evidence bearing on the relationship between the two events.⁶² The ultimate

but rather that the exchange itself fell without the scope of section 351, and the Board considered the issue on that basis.

The Board, with four dissenting votes, found for the taxpayers, indicating that it regarded the business purpose doctrine set forth in *Gregory v. Helvering*, 293 U.S. 465 (1935), as inapplicable to transactions meeting the literal requirements of section 351. But see *Electrical Sec. Corp. v. Commissioner*, 92 F.2d 593 (2d Cir. 1937), discussed in 3 MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.46; Rev. Rul. 55-36, 1955-1 CUM. BULL. 340. This, however, as the balance of the brief *W. & K. Holding Corp.* opinion shows, meant merely that the Board would not deny the applicability of the section because the transfer had been motivated solely by tax savings. Thus the Board felt it necessary to find, as a fact, that there had been no preexisting agreement to redeem the preferred stock. If, as the dissent thought, such an agreement did exist or could be inferred, the result would presumably have been otherwise, whether *Gregory* principles applied or not. Clearly enough, the case ultimately turned on the narrow factual issue of whether the corporation had intended to distribute the proceeds of the securities, with the court, somewhat remarkably, finding this issue for the taxpayers. Had the Board concluded that the redemption was integral to the original exchange, the latter event would no doubt have been treated, in the Board's words, as "a sale with payment deferred."

The problem in a sense is the inverse of that presented by the "reincorporation" cases. See *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955). Compare *Standard Realization Co. v. Commissioner*, 10 T.C. 708 (1948).

61. See *W. & K. Holding Corp. v. Commissioner*, *supra* note 60.

62. See *Mintz and Plumb, Jr., Step Transactions in Corporate Reorganizations*, N.Y.U. 12TH INST. ON FED. TAX 247, 249 (1954). And see *Grubbs v. Commissioner*, 39 T.C. 42 (1962); *Rosenberg's Estate v. Commissioner*, 36 T.C. 716 (1961). In *Rosenberg's Estate*, the taxpayers, shareholders in a family corporation, in a recapitalization received new common stock plus Class B preferred stock in exchange for their old common. The Class B preferred stock was convertible into Class A preferred stock, the latter, unlike the former, being subject to a mandatory redemption provision which provided for retirement of 7% of the outstanding Class A shares annually. Shortly after the recapitalization, the taxpayers sold their Class B preferred to certain institutional investors, which promptly exercised the conversion privilege. The court, emphasizing the ultimate effect of the mandatory redemption feature, sustained the Commissioner in finding that the sale of the Class B preferred was equivalent to a cash dividend distribution from the corporation to the taxpayers. *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1963), reached a contrary result on similar facts. Both cases arose under the 1939 Code and prior to the enactment of present section 306.

question is whether redistribution is integral to the exchange fund arrangement as a whole; whether exchange and redistribution represent a cycle. If this question can be answered affirmatively, the original exchange of securities for shares of the fund would appear to constitute a sale of property with payment deferred at the option of the payee, and it might on that account be viewed as a closed transaction.

Further, since only "stock or securities" are permitted to be received tax-free in a section 351 exchange, another and narrower way of expressing the same conclusion may also be at hand. Without pausing to consider whether the "continuity of interest" doctrine⁶³ developed under the reorganization sections applies with equal effect under section 351,⁶⁴ it is evident that the terms "stock" and "securities" are subject to a largely analogous construction and are to be read and understood in the light of the statutory purpose to distinguish between sales of property and mere asset-ownership readjustments.⁶⁵ Consistent with this aim, the term "securities," although permitting the receipt of debt under section 351, has been interpreted to exclude short-term obligations on the ground that such obligations have a near-cash status.⁶⁶ Whatever uncertainty there may be about the requisite dura-

63. "Requisite to a reorganization under the Code [is] . . . a continuity of interest . . . on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization." Regs. § 1.368-1(b). The familiar history of the "continuity of interest" doctrine is summarized in BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 393-99 (1959). In *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), the properties of one corporation were acquired by another in exchange for short-term promissory notes plus cash. Although there was literal compliance with the statutory definition of a "reorganization" as it then stood, the court held that "reorganization" contemplates "a continuance of interest" on the part of the transferors and that such a "continuance" was lacking in the circumstances. The Supreme Court reached the same result in a similar transaction in *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933), stating that to qualify for tax-free treatment "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes." *Id.* at 470. The Court held also that the short-term notes did not qualify as "securities." *But see*, as always, Griswold, *Securities and Continuity of Interest*, 58 HARV. L. REV. 705 (1945). And see, *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Helvering v. Watts*, 296 U.S. 387 (1935); *LeTulle v. Scofield*, 308 U.S. 415 (1940).

64. See BITTKER, *op. cit. supra*, note 63, at 77-78.

65. *Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1st Cir. 1940). See BITTKER, *op. cit. supra*, note 63, at 75-76.

66. It is usually said that debt having a term of less than 5 years will not qualify as "securities" under section 351. See discussion in *Camp Wolters Enterprises, Inc. v. Commissioner*, 230 F.2d 555 (5th Cir. 1956). See also Rev. Rul. 56-303, 1956-2 CUM. BULL. 193, holding that notes of less than 4 years' maturity are not "securities." Short-term debt was found not to constitute "securities" in the *Pinellas* case, *supra*, note 63, and it has been held that the term "securities" has the same meaning for purposes of section 351 as in the reorganization provisions. *Lloyd-Smith v. Commissioner*, 116 F.2d 642 (2d Cir. 1941).

tion of qualifying indebtedness, it is thus apparent that "securities" is not a term of unlimited application. No more reason exists to suppose that "stock" is always self-defining,⁶⁷ or that it includes anything other than the evidence of a long-term and continuous capital commitment on the part of a taxpayer seeking non-recognition under the section.

As an original matter, it might be doubted whether corporate shares which are fully redeemable at the holder's option constitute "stock" for the purposes of section 351 and the analogous reorganization provisions. A security, however designated, which entitles its holder to withdraw corporate assets at will hardly qualifies as evidence of an extended commitment of capital to the corporate enterprise. Indeed a selling feature of such redeemable shares is that they maximize the holder's independence from the corporation by enabling him to terminate his participation by "putting" his shares to the corporation at net asset value whenever he chooses. To be sure, the owner of non-redeemable shares can terminate his interest in the corporation through sale. But the ability to sell does not assure a price equal to the liquidation value of the corporate assets attributable to the seller's shares, as is evident from the fact that the shares of many closed-end investment companies are available at a discount from net asset value.⁶⁸ Moreover, a sale of outstanding shares, unlike a redemption, has no effect on the corporation's ability to retain control of its property.⁶⁹ It is also true that the redemption privilege is optional rather than mandatory and in theory need never be exercised. This, however, may be less significant under the "continuity of interest" test (or alternatively under the requirement of "stock or securities") than the fact that the shareholder is thereby free to withdraw invested capital at will.⁷⁰ Thus

67. See *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960), holding that certain certificates of contingent interest were "stock" rather than "other property" within section 356(a)(1). And see Regs. § 1.351-1(a)(1), stating that stock rights or stock warrants are not "stock or securities" under section 351; *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942).

68. See ARTHUR WIESENBERGER, *INVESTMENT COMPANIES* 286-89 (1965 ed.).

69. "Shareholders of mutual funds have a power unparalleled in stockholders elsewhere. They can strip the fund of assets; for they do not merely sell, they redeem. Fund managers live under the shadow of this power, and it haunts every move they make. Unlike other corporate managers who retain control of assets unaffected by turnover of the stockholder list, fund managers have, at daily hazard, the disappearance of the fruits of their labor and expense." Lobell, *A Critique of the Wharton School Report on Mutual Funds*, 49 VA. L. REV. 1, 54 (1963).

70. The status under "continuity of interest" principles of stock redeemable at the holder's option seems to have received little public consideration, although the question is adverted to in the American Law Institute study *infra*, note 80, at 284. See also, Rev.

no one would suppose that a demand note is to be treated as a "security" under section 351 or the reorganization sections merely because the note holder may choose to continue his investment on a day-to-day basis.⁷¹

Speaking generally, open-end mutual funds, including those of the conventional variety, exhibit both corporate and non-corporate characteristics. In their corporate aspect, the funds serve as a vehicle for the formation of an asset pool of sufficient size to attract the services of professional management and to make possible extensive portfolio diversification. In their non-corporate aspect, they are obliged to permit their participants to withdraw corporate capital at pleasure. The latter, however, is perfectly consistent with the well-accepted proposition that the relationship of shareholder to fund is essentially that of customer to supplier:⁷² if the shareholder grows dissatisfied with the investment service provided by the fund, it is understood that he will end his patronage by presenting his shares for redemption. State corporate laws which bar the issuance of shares redeemable at the holder's option thus usually make an exception for the shares of open-end investment companies,⁷³ presumably in recognition of the fact that share ownership really represents a terminable service contract and that the corporation need have no "backbone"⁷⁴ in the traditional sense of a permanent commitment to stated capital.

Rul. 56-345, 1956-2 CUM. BULL. 206. It has been held that preferred stock callable by the issuing corporation on 30 days' notice meets the continuity of interest test, *Schweltzer & Conrad Inc. v. Commissioner*, 41 B.T.A. 533 (1940), but such a provision is easily distinguished from one entitling the shareholders to withdraw at will. The call feature is for the protection of the corporation, not the shareholders, and there is no assurance that the latter's stock will ever be redeemed. Closer to the situation at hand, perhaps, is preferred stock subject to a fixed redemption date. Although the Supreme Court in *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935), found the requisite continuity where assets were transferred for redeemable preferred stock and cash, the Court did not refer to the redemption feature of the shares received, having chiefly been concerned to state that the absence of voting rights and management participation was no bar to a "reorganization." The Board of Tax Appeals, on the other hand, stressing the provision for retirement, viewed the stock as amounting to "little more" than the short-term purchase money notes that had been condemned in the *Pinellas* case. 28 B.T.A. 529, 542.

The focus of the reorganization provisions, and of section 351, is on the exchanging shareholder, with the intention being to relieve *him* of gain recognition in appropriate circumstances, and the continuity of interest requirement, therefore, tests the strength of the shareholder's commitment to the entity. Arguably, an option to withdraw invested capital at will reveals a basic absence of commitment, even though, at a given moment, the option remains unexercised.

71. See note 66 *supra*.

72. See ARTHUR WIESENBERGER, *op. cit. supra*, note 68, at 21.

73. See CALIF. CORP. CODE §§ 1101 and 1716.

74. See *Ecker v. Western Pacific R. Corp.*, 318 U.S. 448 (1943), cited in BALLANTINE, CORPORATIONS 619 (1946).

But appropriate as it is to the customer-supplier relationship, the privilege of free redemption may be inconsistent with the purpose of section 351 in permitting two or more persons to form a corporation without recognition of taxable gain. In effect, the question is whether there is a true pooling of assets in these circumstances,⁷⁵ or whether the terminable nature of the service relationship, which is specifically intended, vitiates the tax-free exchange. In return for his appreciated property, the investor receives, among other things, a right to obtain cash or its equivalent in marketable securities from the corporation on demand. In this respect at least, the transaction bears little resemblance to the formal asset-ownership readjustment that is contemplated by the section.

One is aware, nevertheless, that mergers in which conventional mutual funds play the role of acquiring corporation are common, and that the Service generally does not view the presence of redeemable shares as a bar to tax-free status.⁷⁶ The optional nature of the re-

75. Compare Conwill, *Blight or Blessing? The Wharton School Study of Mutual Funds*, 18 BUS. LAW 663 (1963): "These two features—redemption and continuous offering—distinguish the mutual fund or open-end company from the closed-end investment company. A closed-end company neither redeems its shares nor engages in a continuous public offering of its shares The closed-end operation is a pool and mutual operation in a real sense, but for some reason obscure to me industry parlance uses the term "mutual fund" only in relation to open-end companies." *Id.* at 663-64.

76. "More than \$300 million have been added to investment company assets during the past seven years through the merger of personal holding or private investment companies with existing mutual funds and closed-end companies. Approximately eighty mergers of this type have taken place. The private funds involved have ranged in size from \$39 million downward to about \$200,000." ARTHUR WIESENBERGER, *op. cit. supra* note 68, at 96.

In T.I.R. 309 (March 3, 1961), the Service announced that no rulings would be issued on the applicability of section 368, relating to tax-free reorganizations, to the acquisition by one investment company of another "where, as a result of such acquisition, the shareholders of either company, or both companies, thereby achieve a substantially wider diversification of the investment assets underlying their stock holdings." The Release principally affects two types of situations. In the first, a closely-held operating company terminates its business and converts its operating assets into cash. Since liquidation would produce a capital gains tax to the shareholders, the company instead merges into a public investment company, with the shareholders surrendering their closely-held stock for shares of the fund. In the second, a private investment company already in possession of a portfolio of securities desires to obtain professional management services by merging into a public investment company. In both cases, since the only consideration paid by the public company for the assets or shares of the private company will be voting stock, it is expected that the transaction will qualify as a reorganization, e.g., under section 368 (a)(1)(C), and that receipt of the public company's stock by the shareholders of the private company will be tax-free under section 354(a). See generally, Greene, *Tax Techniques of Acquisitions by Mutuals of Closely Held Investment Companies*, 13 J. TAXATION 2 (1960). See also note 43 *supra*.

Following T.I.R. 309, the Service apparently for a time refused to issue rulings even where the element of "wider diversification" was lacking. See Bierman *et al.*, *supra* note 9, at 998. More recently, however, the Service has recommenced to issue favorable rulings on a showing that the securities held by the private company are distributed among the same

demption privilege (any shareholder who desires to do so may retain his shares indefinitely), together with the view that redemption is a mere alternative to sale (the issuing corporation simply makes the market in its shares), may be the reasons for the Service's permissiveness in this connection.⁷⁷ But even if these points are accepted as supporting non-recognition for redeemable shares generally, the fact is that neither applies without considerable qualification to the shares of an exchange fund.

As previous analysis has shown, the period of share ownership in the exchange fund is as a practical matter likely to be limited by the investor's tax-postponement needs, redemption being a predictable event rather than an indefinite one.⁷⁸ In contrast, the owner of shares

categories—"Automotive," "Banks & Financial," etc.—as those of the public fund. Note, 22 J. TAXATION 62 (1965). Here, however, the anticipated ground for an attack by the Service—failure to continue the business of the merging company—was apparently abandoned as a consequence of adverse court decisions. Rev. Rul. 63-29, 1963-1 CB 77; *Bentsen v. Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961). See also, Tarleau, "Continuity of the Business Enterprise" in *Corporate Reorganizations and Other Corporate Readjustments*, 60 COLUM. L. REV. 792 (1960).

Quite obviously, a reexamination by the Service of the tax status of shares redeemable at the holder's option would have consequences for mergers involving mutual funds as the acquiring party.

77. See *Fifth Avenue Bank of New York v. Commissioner*, 31 B.T.A. 945, 950 (1934), *on rehearing*, 32 B.T.A. 701, *aff'd*, 84 F.2d 787 (3d Cir. 1936).

78. Central to the legal arguments suggested in the text is the point that the ownership of shares in an exchange fund is necessarily temporary. This "temporariness" is a consequence of the pooling by large numbers of investors of deferred tax liabilities which currently are or ultimately will be unequal. However, the deferral of tax depends in the first place upon the assumption that section 351 is applicable to the original exchange. If section 351 did not apply, the fund would be equivalent to one that had been formed for cash, and none of the circumstances stressed in the analysis would obtain. Accordingly, it might be objected that any argument disputing the applicability of section 351 which grows out of an analysis of the effect of tax-pooling suffers from circularity. Thus, is it not illogical to assert that the conditions present after a favorable application of the section has been assumed may in turn be thought to cast doubt upon the section's initial applicability?

The answer would seem to be that the temporary nature of share ownership in exchange funds is the consequence, not of the application of section 351, but of the act of combining separately-owned assets which are unequal in net value to begin with. Inequality is present because the properties combined have appreciated in different degrees while in the hands of the individual investors, and the potential tax liability per X dollars of property therefore varies from person to person. In these circumstances the investors might choose to reflect their differing equities by adjustments to the exchange value of their respective contributions; or they might be indifferent to the disparities among them. In either case the factor of differing equities would cease to play a part in the investor's decision to stay with or withdraw from the pool as time passed. But, the exchange fund investors are neither indifferent to net value disparities, nor do they wish to reflect those disparities by adjusting exchange values. The apparent conflict in aims is resolved by enabling each investor to withdraw from the fund at such time as his own tax liability has been relieved or he elects to reassume that liability individually, that is, by the issuance of

in a conventional fund redeems on the basis of his investment judgment and is not compelled to do so by what may be called the tax economics of the arrangement. Moreover, the obligation of the exchange fund to redeem its shares is not merely an equally acceptable substitute for the sale of such shares to outsiders; rather, redeemability is specifically designed to preserve investor net worth even though the long-range consequence is the destruction of the fund. In the case of conventional funds, there is at least a possibility that the public would offer as much as or more than net asset value if the shares were non-redeemable. In addition, for conventional funds, the function of the redemption privilege, in part, is to support or justify the continuous offering of new shares to the public.⁷⁹ Redeemability is thus expected to promote the growth, not the decline, of the conventional fund's investment capacity.

CONCLUSION

There is occasionally a tendency to downgrade the significance of tax-postponement on the ground that the question is merely one of "tax now or tax later." But the scope of the non-recognition provisions, as has been said elsewhere and often,⁸⁰ is important under our tax system for three reasons. First, a gain that is not recognized when an exchange takes place may never be recognized by virtue of the adjustment in basis that occurs at the taxpayer's death. Even though it is true that technical questions relating to the application of particular Code sections cannot properly be resolved by reference to the ultimate irrationality of the death-basis rule, nevertheless the existence of a provision which forgives tax at death gives a special urgency to the

shares redeemable at the holder's option. The prospect of a stepped-up basis at death similarly gives rise to a need for a redemption privilege.

Section 351 does not *create* the differences in investors' equities. Nor does it *create* the conditions under which a pooling of securities which have appreciated in varying degrees will be acceptable to the investors. It seems incorrect, therefore, to say that section 351, being first assumed to apply, then in effect produces the circumstances necessary to a finding of "temporariness." Rather, the question is whether an arrangement which must be placed upon a temporary footing in order to satisfy investors' objectives nevertheless succeeds in meeting the requirements of the section.

The matter is admittedly clearer if the pooling can be viewed as separate from the section 351 issue. Where gain and liability are related, the consequence may simply be that the effort to satisfy the section is self-defeating.

79. See Greene, *The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940*, 37 U. DET. L.J. 369, 388 (1960); SEC Report of Special Studies of Securities Markets, Part 4, p. 97, H. Doc. No. 95, 88th Cong., 1st Sess. (1963).

80. See A.L.L., *INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS* 267 (1958); Hellerstein, *supra* note 8.

question whether or not a particular exchange qualifies for tax-free treatment. Second, the present postponement of tax affords the taxpayer an opportunity (not available to others making taxable exchanges) to select the point at which a final recognition of gain will produce the most favorable tax result. He may wait for a rate reduction if, as at the present, there is some reason to expect one, or he may delay recognition until there has been a realization of offsetting capital losses. Finally, and most important, the tax law contains no general exemption for non-cash exchanges. And whatever may be said for the familiar proposal to postpone tax on sales of appreciated securities if the proceeds are reinvested in other securities,⁸¹ such a privilege is not now available to the investing public in general and is essentially contrary to the present basic policy of the Code. Although the Code contains important exceptions to that policy, as in the like-kind exchange and reorganization areas, those exceptions are still relatively narrow and specific. Certainly they cannot be cited as justifying the accidental introduction of a major tax-postponement device, especially one whose use is, as a practical matter, restricted to wealthy investors.

The development of the capital exchange fund as a device for the avoidance of federal tax on dispositions of appreciated securities is a tax-planning achievement of more than ordinary impact. Although the oldest of the exchange funds—the renowned Centennial Fund, formed with assets of less than \$27 million—has been in existence for only five years, investor response to the basic conception of the exchange fund has been so enthusiastic that the number of such funds now stands at eighteen.⁸² The value of initial assets was in excess of \$700 million at the end of 1964 and may have reached \$1 billion at the present writing. This proliferation is the more striking for having taken place in the face of two discouraging influences: the first, but least serious, has been the inability of the exchange funds to obtain formal approval of the tax status of fund formations from the Internal Revenue Service; the second is the unfavorable, or at best wary, reaction of some investment analysts to the performance record of the exchange funds as investment media. Notwithstanding, those fund management organizations which are most active in the field have succeeded in producing new and sizable funds on a nearly annual basis for the last few years; and since additional funds presumably are even now in the formative stage it is evident that the outlook for the exchange fund industry, at least from the standpoint of the fund promoters, is distinctly bullish. No one, however, has yet suggested that

81. See SMITH, *FEDERAL TAX REFORM* 119 (1961).

82. ARTHUR WIESENBERGER, *op. cit. supra* note 68, at 96 and 272 (1965).

exchange fund formations have a legitimate claim in policy to tax-free treatment, and if a reasonable argument can be made for disqualification under section 351, they ought, in a "wise administration of the revenue system,"⁸³ to be opposed.

The principal purpose of the exchange funds is to mutualize investor risks without precipitating the recognition of taxable gain. Of course, any corporate formation which involves the contribution of diverse properties by two or more persons produces a distribution of risk among the contributors, and there is no doubt that section 351 contemplates such a result when it permits a tax-free pooling of separately-owned assets. What the section should not be supposed to contemplate, on the other hand, is an arrangement geared to the satisfaction of individual tax-postponement needs through the redistribution of corporate property to the shareholders at their request. Analysis suggests that redistribution is integral to the exchange fund arrangement and that the funds could not, consistent with their role as a tax-suspension device, be organized on the basis of either a permanent capital structure or one capable of expansion.

This flaw—though it is more than that—could provide a technical basis for an attack on the tax-free status of exchange fund formations, if the Service now resolved to make one. Such a resolve, on the other hand, coming after a fairly lengthy period of apparent acquiescence by the Service, would appear to raise some question of fairness if applied to completed transactions. And although no taxpayer could legitimately claim to have relied entirely on the Service's failure to assert deficiencies in other instances, it would be understandable if the Service, having at long last arrived at the position that fund formations are indeed taxable, should nevertheless choose to express that position in terms of a prospective application only.⁸⁴

83. See Caplin, *supra* note 11, at 16.

84. A determination that exchange fund formations are taxable would presumably result in a windfall for those funds which were formed in a year now barred by the statute of limitations, unless at the time such funds were formed the Service extracted agreements that they would not subsequently claim a basis for the securities originally received higher than the individual transferors' bases. I.R.C. §§ 1311-1314, which mitigate the effect of the statute of limitations in some circumstances, although applicable to the individual shareholders, would not apply to the corporate transferee. See Regs. § 1.1312-7(c), *Example* (1). Conceivably, on the other hand, since capital gains realized by a regulated investment company are in effect passed through to the shareholders, some ground might be found by the Service for the assertion of an estoppel—especially since the existing shareholder group includes no one not included in the original transferor group. See generally, Mintz and Plumb, *Taxing Income in Years Not Realized under Doctrine of Equitable Estoppel*, 1954 So. CALIF. TAX INST. 481 (1954). In cases in which the year of exchange is still open, no doubt the problem could be handled through closing agreements. I.R.C. § 7121.