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TAX TREATMENT OF PARTNERSHIP EXCHANGE FUNDS AND MERGERS OF INVESTMENT COMPANIES

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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CONTENTS

	Page
Summary	1
How an exchange fund operates	2
Present law	3
Issues	5
H..R 11920	9
Administration proposal	10
Proposals submitted by interested persons to committee	11

TAX TREATMENT OF PARTNERSHIP EXCHANGE FUNDS AND MERGERS OF INVESTMENT COMPANIES

Summary

Nature of a swap fund.—An exchange fund, or "swap fund," is an investment company (mutual fund) formed through the deposit of stocks or debt securities by large numbers of investors in exchange for shares of the fund. The purpose of these funds is to allow investors who own appreciated securities to diversify their concentrated investment holdings from one or a few securities into a broader ownership of a variety of other marketable securities without paying tax on their "paper" capital gains at the time they pool their securities with the securities of other persons in the fund.

Status of the law.—Present law does not permit a tax-free transfer of appreciated securities to a corporate investment company where the result is a diversification of each investor's portfolio. This restriction was added in 1966 after a period in the early 1960's when investment management firms publicly solicited individuals owning highly appreciated stocks or securities (usually in large blocks) to pool their stocks in a tax-free exchange for shares in a newly formed corporation which would then manage the combined portfolio.

The 1966 legislation only dealt with swap funds established in corporate form and did not deal with partnerships. During the 1960's some attempts were made to organize exchange funds as public limited partnerships. However, these partnerships would have had to meet various voting and other requirements of the Investment Company Act of 1940, and most State partnership statutes at the time did not permit limited partnerships to meet these security rules. However, in recent years, several States have amended their partnership laws to overcome these problems and the Internal Revenue Service has ruled that partnerships under these amended State laws can be taxed as partnerships for Federal income tax purposes.

In April 1975 the Internal Revenue Service granted a private tax ruling to one exchange fund, which proposed to operate as a limited partnership, allowing investors to transfer appreciated stocks or securities to the fund without a current tax to the investor-limited partners. The ruling prompted the formation of other similar limited (or general) partnerships, including some which propose to offer interests to investors privately (rather than by broad public solicitation). Several of the new funds have ruling requests pending with the Service.

Tax-free diversification also has been obtained by permitting an investor owning a relatively small number of appreciated stocks through a personal holding company to merge its stock or assets with an existing public mutual fund (or through other tax-free provisions to obtain the same result). The public fund would thereby add to its

overall portfolio of stocks and the taxpayer would have effectively diversified his own investments (by owning shares in the mutual fund). These acquisitions have been allowed to occur tax free to the owners of the holding company.

What the bill provides.—H.R. 11920 would conform the partnership tax rules to those for corporations in the case of exchange funds and make taxable the transfer of appreciated stocks or securities (as well as other property, such as real estate) to an investment company organized as a partnership if, as a result, the transferors' interests are diversified. The bill would also make mergers and other reorganizations taxable where a publicly held mutual fund acquires a family held personal holding company, or where two or more publicly held mutual funds merge with each other. The bill would apply to transfers of stock or assets made after February 17, 1976.

How an Exchange Fund Operates

An individual who owns a sizable block of appreciated stock in a public corporation often feels a need to diversify his holdings in order to minimize his risk. Ordinarily, a decision to diversify involves selling the appreciated stock for cash and reinvesting the proceeds. However, a sale for cash will usually result in a capital gains tax (and usually also involve State taxes). As a result, an exchange fund, or "swap fund," is an attractive vehicle to enable investors to diversify their existing investments if there will be no tax liability on the appreciation in value of the investor's stocks or securities at the time he pools them with others in the fund. This advantage is typically described in a swap fund prospectus as follows:

> "The purpose of the Fund is to provide investors holding substantial blocks of low tax basis securities considered appropriate for the Fund's portfolio with a method of diversifying their holdings without realizing any gain for Federal income tax purposes at the time of exchanging such securities for Fund shares. Investors in the Fund will secure the benefit of experienced and continuing professional investment management * * *. The Fund has been organized as a limited partnership rather than a corporation because a partner contributing property to a partnership in exchange for partnership interests does not incur any Federal capital gains tax."[1]

A swap fund is typically formed with a cash contribution by the fund's investment manager (usually a professional investment advisor) which will also supervise the portfolio once the fund is underway. Interests (or "shares") in the fund are registered with the Securities and Exchange Commission (in the case of public offerings) and then offered to prospective investors by means of a prospectus. Units of interest are distributed through securities dealers at a cost to the purchaser of a subscription fee (sales charge) paid to the soliciting dealer or the dealer-manager, or both. The fund usually prescribes a minimum dollar value per depositor and also a minimum total value

[1] Preliminary Prospectus of State Street Excange Fund (December 19, 1975), p. 3.

of all deposits which must be met before the exchange will take place. A list of representative securities deemed acceptable by the manager on the basis of their blue-chip or other investment quality is also included in the prospectus. The fund also reserves the right to accept or reject any security offered for deposit.

Units of partnership interest (shares) are sold to the public not for cash but for an investor's appreciated securities, which must be acceptable to the fund manager. The investors deposit their securities (along with information relating to their tax basis) in a "depository" bank during a limited solicitation period. After the solicitation period, the fund sends to each depositor a list of all securities tendered, showing their current market values and tax basis of the different shares. For a period thereafter, usually 30 days, the fund may reject specific stocks offered or a depositor may withdraw his deposited stocks. In this way the fund and each investor can evaluate the total "mix" of investments offered.

Unless withdrawals by depositors or rejections by the fund's manager reduce the total market value of the acceptable securities remaining on deposit below the fund's minimum portfolio size, the exchange of the securities deposited for interests in the fund then takes place without further action by the depositors. The exchange at this point involves the final binding transfer of investors' shares into the fund.[2]

After the fund begins operating, its paper gains remain untaxed to the investors unless and until the partnership sells the stocks or until a partner sells part (or all) of his interest in the fund. Generally, the fund's portfolio turnover rate is planned to be minimal, or at least lower than the turnover rate of ordinary mutual funds. A typical statement of this policy is expressed in one fund prospectus as follows:

> "Because of the nature of the Fund, it is expected that the portfolio turnover will be low by industry standards and, especially in the early years, should not exceed 10%. One of the factors which will be considered before any portfolio securities are sold will be the resulting tax liability. Changes, however, will be made in the portfolio consistent with the investment objective and policies of the fund whenever such changes are believed to be in the best interests of the Partners, even though capital gains will result." [3]

Present Law

Exchange Funds

Corporate exchange funds.—Under present law (sec. 351 of the code), the transfer of property to a corporation by one or more persons in exchange for stock in the corporation generally does not result in gain or loss if, immediately after the exchange, the person or persons in question are in control of the corporation. In 1966 Congress amended section 351 of the code to deny this nonrecognition treatment on the initial formation of a corporate swap fund. Congressional

[2] The exchange funds are technically "open end" funds, which means that all or any portion of a partner's interest is redeemable at net asset value at the partner's option, which he may exercise at any time.

[3] Prospectus of Vance, Sanders Exchange Fund (January 5, 1976), p. 4.

action in this area resulted from the creation of a number of swap funds in the early 1960's and the problems which the Internal Revenue Service faced with respect to the tax treatment of the funds.[4]

The 1966 amendment specifically applied to transfers to "an investment company." The statute did not define this term further. The Treasury, however, adopted regulations under which, for purposes of section 351, an investment company is defined as a corporation which is a real estate investment trust, a regulated investment company, or otherwise a company over 80 percent of the value of whose assets are held for investment and are readily marketable stock or securities.[5]

A transfer of property to such a company is taxable if the transfer results in "diversifying" the transferors' interests in the total amount of property owned by the company. The regulations provide that a transfer ordinarily results in the diversification of the transferors' interest if two or more persons transfer non-identical assets to a corporation in the exchange.[6]

Partnership exchange funds.—Under present law (sec. 721 of the code), the transfer of property to a partnership by one or more persons in exchange for an interest in the partnership does not result in gain or loss. In the case of exchange funds, there is no restriction (of the type provided in the case of corporations) against nonrecognition treatment of gain or loss on transfers of property to partnership swap funds.[7]

On April 28, 1975, the Internal Revenue Service (after lengthy consideration) issued a favorable private ruling to the Vance Sanders Exchange Fund, a California limited partnership with management headquarters in Boston. The principal holdings of this private ruling were as follows: (1) The fund will be taxable as a partnership rather than as a corporation for Federal income tax purposes; (2) investors contributing stock or securities in exchange for partnership interests will not be taxable at that time on their gains; (3) the fund's basis in the stocks or securities which it receives will be the same as their cost to the investors at the time of the exchange; and (4) each investor's basis in his fund interest will be the same as his basis in the appreciated securities placed in the fund.

Where an exchange fund proposes to operate as a partnership, the fund will not be subject to the existing tax rules for a "regulated investment company" (sections 851–855), since mutual funds under these rules must be domestic corporations. Partnership funds will be governed for securities purposes by the Investment Company Act of 1940 and, for tax purposes, will be governed by the code rules for partnerships generally (sections 701–771).

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[4] When Congress made transfers to corporate exchange funds taxable (in November, 1966), transitional rules were adopted under which the new restrictions did not apply to a corporate exchange fund required to register with the Securities and Exchange Commission if the registration statement was filed before January 1, 1967, and the exchanges were actually consummated by June 30, 1967. In these cases, the fund must have received deposits before May 1, 1967, in a total amount not larger than the maximum size of the fund specified in the registration statement at the end of 1966.

[5] Regulations § 1.351–1(c)(1).

[6] Regulations § 1.351–1(c)(5).

[7] The investor-partner's tax basis for his interest in the partnership is a "substituted" basis; that is, his cost for the stocks which he transferred into the fund (sec. 722). The fund takes a carryover basis in the stock which it receives from the depositor; its basis for future capital gain or loss purposes is the same as the basis in the hands of the depositor (sec. 723).

Mergers of mutual funds and mergers of personal holding companies with mutual funds

Under present reorganization rules (secs. 354 and 368), mutual funds are permitted to merge in tax-free reorganizations. In addition, in certain cases individual investors or small groups of investors who own stocks or securities in a corporation which constitutes a personal holding company have been able to achieve tax-free diversification by merging their personal holding company into a conventional mutual fund in exchange for shares of the fund.[8]

Issues

Partnership exchange funds

Two basic issues are before the committee in the case of partnership exchange funds: whether to conform the partnership tax rules to those adopted ten years ago preventing corporate swap funds to be formed tax-free, and, if this conclusion is reached, whether some type of grandfather rules should be adopted for funds which were in various stages of being organized when H.R. 11920 was introduced.

By some estimates, the 20 to 30 exchange funds formed in the 1960's attracted over $1 billion in appreciated securities. Some recent reports estimate that the partnership funds, if allowed to proceed, could attract a potential market of $10 billion.[9]

Basically, exchange funds offer groups of wealthy investors a way to redistribute stock market risks among themselves while continuing to postpone most tax on their own individual gains. For example, suppose that 10 individuals each own one share of a marketable stock worth $100. Each share is in a different listed company. If all 10 investors pool these stocks in a partnership, each individual instead of owning 100 percent of one stock worth $100 will have a 10 percent interest in ten different stocks having a total market value of $1,000. After the exchange, the value of the taxpayer's investment remains at $100 but the value of his interest in his original stock holding is reduced to $10. In effect, each investor might be viewed as having exchanged $90 of the value of his former investment for $10 in value in each of nine new stocks. If this fund can be formed tax-free, each investor has obtained diversity without owing any tax on the mutual exchanges except to the extent the mutual funds subsequently sell any of its holdings.[10] In a syndicated swap fund, each partner can also draw down the value of his interest at any time he chooses. The entire arrangement, therefore, can be viewed as one which permits each investor to continue tax deferral while at the same time obtaining diversification.

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[8] Where the mutual fund obtains the holding company's stock in a stock-for-stock reorganization under sec. 368(a)(1)(B), it can obtain direct ownership of the portfolio by later liquidating the holding company.

[9] "Exchange Funds Hit the Comeback Trail," *Business Week*, February 16, 1976, p. 70.

[10] Under present law, exchanges of stocks or securities have long been excepted from the Code rules permitting nonrecognition of gain or loss on exchanges of "like kind" properties held for investment or for productive use in a trade or business (sec. 1031). This exception has been justified on the grounds that stocks or bonds are more liquid than real estate or other similar assets and are "essentially like money." H. Rept. 704 (Revenue Act of 1934), 73d Cong. 2d Sess. 1939–1 Cum. Bull (Part 2) 554, 564.

Under present partnership rules, the Treasury reserves authority to treat property distributions among partners as involving, in substance, a direct taxable exchange between or among the partners. Regulations section 1.731–1(c)(3). In light of this regulation, the partnership swap funds which are seeking an IRS tax ruling represent that an investor who wants to be redeemed out during the first five years of his membership in the fund will only receive stock of the same company which he contributed to the fund (rather than stock of other companies).

A swap fund operated as a partnership is especially attractive in this regard because the partnership tax rules arguably allow the partners to withdraw stocks or other assets in kind from the fund tax free (sec. 731).

This way of viewing an exchange fund may explain why a wealthy individual who has successfully managed his own investments but concentrated in a few blue-chip stocks and who fears he may subsequently be exposed to serious risks of loss in a falling market is attracted to an exchange fund. Another group attracted to these arrangements are the owner-founders of successful businesses which started small but over the years have become successful and may have gone public with all but the founder' stock holdings. Senior corporate executives who have exercised large numbers of stock options in their employers may also be looking for ways to diversify their concentrated holdings without tax consequences. Other potential depositors are businessmen who formerly owned a successful small business and on retirement merged their company with a conglomerate but now hold top-heavy amounts of that company's stock.

One argument advanced by those who favor the tax-free formation of swap funds is that individual owners or entrepreneurs may not be interested or skilled in making stock market transactions. If their exchanges would be taxable, many of these individuals (it is argued) will die owning their top-heavy portfolios despite the risks of continuing in that position. But such persons, it is said, can be attracted to an exchange fund in which professional managers will make objective decisions whether and when to sell off the depositors' stocks. In any event, the owner will be taxable when and as the manager decides to sell part (or all) of the stock, but not before that time. Of course, one difference between turning over appreciated stocks to a professional manager directly and doing so through an exchange fund is the interest in other stocks which the owner gets by joining a swap fund. The issue is whether this diversification and the opportunity, in effect, for each investor to defer tax on the exchange he makes with other investors should be permitted tax-free through a partnership (when this cannot be done through a corporation or a direct exchange).

Another argument for forming an exchange fund without current tax is that the large paper gains which went unrealized in the hands of the individuals will be "unlocked" in the hands of the fund as the professional managers begin changing its overall mix of stocks. Since it is presumed that most depositors would have otherwise retained their shares indefinitely, the argument is that a swap fund actually generates tax revenue which the Treasury would probably not have otherwise received. However, the funds themselves advertise that they will have a low or minimal portfolio turnover rate.

Critics of swap funds argue that the fund's basic aim is less to manage an investment business than to enable investors to diversify without owing taxes at any earlier date than they would have chosen themselves. The right of each partner to have his interest redeemed at any time suggests that each investor (in addition to the fund's manager) can determine when he will draw down the interest in other stocks which he bargained for when he joined the fund, and each investor will in effect determine when he owes taxes on this delayed exchange. As a partner's basis for his fund interest increases over time, he may in fact become less interested in continuing to defer taxes and may be expected to "put" his interest back to the fund. In this view, a swap fund operates unlike a conventional partnership or corporation. In effect, each investor in a swap fund tends to be interested chiefly in his own tax needs and thus uses the fund as his agent for making a tax-free exchange with other investors. This type of situation may differ significantly from the kind of transaction which the partnership tax rules (sec. 721) might be thought to cover. Critics also point to the role played by brokers and the payment of sales charges as supporting this view of a swap fund.[11]

Trusts.—Although it does not appear that swap funds have been formed as trusts, it might be possible in the future for investment managers to develop a trust format which would offer advantages similar to those of a partnership exchange fund. A common trust fund (sec. 584), for example, might possibly be developed as such a vehicle. The committee may want to consider restricting at this time the possible tax-free formation of swap funds as trusts.

Grandfather rules.—As indicated earlier, several partnership exchange funds were in various stages of being organized or completed when H.R. 11920 was introduced. The Vance, Sanders fund had previously obtained a tax ruling and is the only such partnership to have done so before the Service stopped its issuance of further rulings on partnership swap funds pending definitive action on the pending legislation. However, none of the funds (including Vance, Sanders) had actually consummated exchanges with investors by the effective date of the bill (transfers occurring after February 17, 1976). Other partnerships had begun to be organized in late 1975 and, by the introduction of H.R. 11920 on February 17, 1976, were in various stages of registering their proposed public offering with the Securities and Exchange Commission, applying for an IRS tax ruling, lining up brokers and dealer-managers, and soliciting expressions of interest from potential depositors.

Table 1 shows the partnership funds currently known to be in the process of formation and the dates on which they either received or filed for a tax ruling on the taxfree status of transfers into the fund. There may be other partnerships in which exchanges have already occurred or are in process, but which are privately formed in reliance on opinions of counsel without seeking a tax ruling. Such funds, if any, did not testify at the committee's hearing on March 29, 1976.

Representatives of the existing funds have proposed various grandfather rules under which H.R. 11920, if enacted, would not apply to funds in process of being formed on February 17, 1976, and which were far enough along under present law (in terms of expenses incurred and actions taken) to claim a reliance interest. These are set forth further below.

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[11] In 1966 before Congress amended the code, the Treasury proposed regulations under section 351 which would have made transfers to corporate swap funds taxable. These proposed regulations described the net effect of the transaction as "an immediate or delayed marketplace sale or exchange of stock or securities."

TABLE 1.—PARTNERSHIP EXCHANGE FUNDS WHICH RECEIVED A PRIVATE TAX RULING OR APPLIED FOR SUCH A RULING BEFORE MAR. 29, 1976

[The following list reflects information known to the committee]

Name of fund	Form	Minimum individual deposit (market value)	Minimum total deposits required (market value) (millions)	Ruling request filed
Vance, Sanders Exchange Fund	California limited partnership (public offering).	$25,000	$25	[1] Nov. 22, 1972
State Street Exchange Fund	Massachusetts limited partnership (public offering).	25,000	30	Nov. 7, 1975
Fidelity Exchange Fund	Nebraska limited partnership (public offering).	25,000	25	Dec. 24, 1975
American General Exchange Fund	California limited partnership (public offering).	25,000	25	Nov. 14, 1975
Boston Co., Exchange Associates	Massachusetts limited partnership (private offering).	500,000	5	Feb. 2, 1976
Chestnut Street Exchange Fund	California limited partnership (public offering).	15,000	25	Mar. 26, 1976
Equity Exchange Fund [2]	New Jersey general partnership (public offering)	25,000	25	Mar. 26, 1976

[1] Favorable ruling issued Apr. 28, 1975.

[2] On Jan. 29, 1975, this fund obtained a ruling from the Internal Revenue Service that the partnership would be taxable as a partnership and not as a corporation. The proposed fund managers planned at that time to engage in buying municipal bonds. After the ruling to the Vance Sanders fund became widely known, the managers of this fund changed its proposed business and began planning to operate it as an exchange fund. A second ruling request was then submitted on Mar. 26, 1976 on the question whether taxfree transfers could be made to the partnership if it operated as a diversification fund.

The Equity Exchange Fund proposes to have a unit investment trust (sec. 851(f)) as a general partner and then to syndicate to individual investors interests in this general partner (the unit investment trust). This fund had not actually filed its regulation statement with the SEC by March 29, 1976, but was in the process of preparing the statement by that date.

Since Vance, Sanders had gone furthest in soliciting and receiving deposits from potential investors, the relevant facts of this fund to date are as follows. The fund's registration statement was filed with the SEC on September 30, 1975, after which it began to solicit deposits. The prospectus became effective on January 5, 1976, and the fund then began accepting deposits from investors (subject to later withdrawal or rejection). The solicitation period ended on February 23, 1976. The dollar value of deposits (at March 12, 1976, the fund's last valuation date) are as follows.

Deposits received by or mailed to the depository bank on or before Feb. 17, 1976	$104,000,000
Deposits received or mailed by Feb. 23, 1976, pursuant to investors' commitment made by February 17	20,000,000
Subtotal	124,000,000
Deposits received or mailed by Feb. 23, 1976:	
Informal notice of intent from investor by February 17 but legal restrictions to be cleared up, etc	15,300,000
Deposits received in excess of investors' commitments by February 17	3,600,000
Deposits pursuant to other indications of investor intent short of actual notice	2,600,000
Deposits without commitment or notice of investors' intent by February 17	5,000,000
Total	150,500,000

Mergers of conventional mutual funds

It has been suggested that reorganizations involving two or more conventional mutual funds (regulated investment companies within the meaning of sec. 851 of the code) which are publicly held have occurred, or may occur, in order for a profitable fund to utilize unrealized capital loss carryovers of an unprofitable fund. In this type of situation, the acquired company's losses would not have been realized in previous years through sales of some of its stocks at a loss since many of the marketable stocks which it holds have declined in value and would produce a realized capital loss if they were to be sold.

The question is whether a profitable mutual fund would be interested in, or could, successfully acquire another mutual fund having built-in losses of this kind partly (or chiefly) in order to sell the loss stocks after the merger and offset the realized losses against gains from sales of its own profitable stocks. This question differs from the diversification or swap fund problem discussed earlier.

Industry representatives have stated to the committee that mergers of publicly held mutual funds usually have predominant business motives, such as improving the management of one or both of the funds, and that in such cases mergers are encouraged by the Securities and Exchange Commission. These spokesmen also say that they are not aware of any mergers which have occurred principally to use capital losses (either as a principal motive or as one of several motives). It is also stated that an investment company which realizes capital losses is effectively prevented from paying out capital gains to its shareholders because under the code capital gains are taxable as ordinary dividends to the shareholders to the extent the fund has realize capital losses reduce the fund's net capital gains. Since fund investors usually want to receive capital gain distributions, it has been said that an acquisition of large potential capital losses would place the acquiring fund in a disadvantageous position vis-a-vis its own investors and vis-a-vis other profitable funds.

Mergers of personal holding companies into publicly held mutual funds

The broad question before the committee in this area is whether reorganizations of closely held companies into mutual funds should be permitted to occur tax free. This type of acquisition closely resembles swap funding when the principal purpose is to obtain diversification.

H.R. 11920

The bill, H.R. 11920, was introduced on February 17, 1976, by Mr. Ullman and is cosponsored by Mr. Corman, Mr. Schneebeli, Mr. Conable, Mr. Mikva, Mr. Gibbons, and Mr. Stark. The bill contains two basic provisions.

(1) *Exchange fund amendments.*—The bill amends the partnership rules of the code to require recognition of gain on a transfer of property to a partnership if the partnership would be treated as an investment company (within the meaning of sec. 351) if the partnership were incorporated.

This rule would apply to limited partnerships and general partnerships, regardless of whether the partnership is privately formed or publicly syndicated.

The term "investment company" is not defined in this provision of the bill.[12]

The effect of this provision is to incorporate into the partnership area the definition of an investment company in the regulations under the corporate swap fund rules (sec. 351). Under these regulations, transfers of stocks or securities to a partnership would be taxable if over 80 percent of the partnership's assets before or after the exchange consist of readily marketable stocks or securities (or interests in regulated investment companies or real estate investment trusts), and if the transfer resulted directed or indirectly, in diversification of the transferors' interest.

The bill would not affect the tax treatment of an investment partnership as a partnership, that is, whether it would be taxed as a partnership or as a corporate-type entity. That classification question would continue to be determined under sec. 7701 of the code.

(2) *Reorganization amendments.*—The bill denies taxfree reorganization treatment (under sec. 368) to exchanges in which either or both parties is an investment company (including a mutual fund governed by the regulated investment company rules of the code).

(3) *Effective date.*—The amendments made by H.R. 11920 apply to transfers of stock or assets made after February 17, 1976 (the date the bill was introduced).

Administration Proposal

The Treasury Department supported H.R. 11920 in its testimony but made the following recommendations for changes in the bill:

(1) While supporting the portion of the bill making taxable the formation of exchange funds organized as partnerships, it recommended a grandfather rule which would allow present law to apply to transfers made to a swap fund partnership within 90 days after the bill is enacted, where—

(*a*) A tax ruling request relating to the transfer was filed on or before February 17, 1976;

(*b*) A registration statement, if one is required, was filed with the SEC on or before February 17, 1976; and

(*c*) The total value of the securities transferred to the partnership does not exceed $100 million or, if greater, the value of securities actually deposited pursuant to the registration statement before February 29, 1976.

(2) It also suggested that the restrictions against swap funds be extended to trusts.

(3) It suggested that the portion of the bill which would deny taxfree treatment to any reorganization involving an "investment company" is too broad and would deny tax free treatment to many reorganizations which bear little or no resemblance to swap funding. As a

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[12] If the term "investment company" were given the same meaning as in the Treasury's regulations under the corporate swap fund rules (sec. 351), mergers of two or more public mutual funds, which must have diversified portfolios under present tax rules, might not be restricted by this provision.

Under the corporate swap fund rules, a private investment company would be affected if over 80 percent of the value of its assets (apart from cash) consists of readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts. Regulations section 1.351-1(c)(1).

result, it opposed a denial of tax-free treatment to mergers involving only diversified public funds and recommended that the bill be narrowed in this area to deny tax-free treatment to reorganizations involving a personal holding company which is an investment company owning stocks and securities in an undiversified portfolio in which substantial net appreciation has occurred.

Proposals Submitted by Interested Persons to Committee

The following is a general summary of the views submitted to the committee on behalf of interested persons at the public hearing conducted on March 29, 1976. In general, the views and proposals of those who testified at the hearing relate to the provisions of H.R. 11920. This section is divided into three parts: the first part deals with those commenting on the provisions of the bill dealing with exchange funds; the second part deals with those commenting on the provisions of the bill relating to mergers of mutual funds (including personal holding companies); and the final part includes the witnesses who commented generally on the bill.

A. Exchange funds

Vance, Sanders & Company, Inc., represented by M. Dozier Gardner, Vice President and Director

(1) Opposes the provision of the bill which would make transfers to exchange funds taxable, but argues that the Vance, Sanders Exchange Fund should be grandfathered from any general restriction which the committee decides to impose on swap funds. Argues that the effective date of H.R. 11920 is unfair to the Vance, Sanders fund which not only incurred direct expenses of $349,000 (plus indirect expenses of $197,000), but did so relying on a private ruling from the Internal Revenue Service. Also, indicates that brokers earned $4.7 million in commissions in solicitations for the fund.

(2) Recommends that in order to protect the Vance, Sanders fund, H.R. 11920 should not apply to transfers to a partnership which had received a tax ruling before February 18, 1976; had a registration statement in effect before that date; and had begun seeking deposits during a solicitation period which existed on February 17, 1976, even if the period ended after that date. Also, the Fund should be allowed to retain all securities received by it during its solicitation period.

Fidelity Exchange Fund, State Street Exchange Fund, and American General Exchange Fund, represented by Edward C. Johnson, George Bennett, and Charles T. Bauer, respectively

(1) Argue that exchange funds operated in corporate form (and grandfathered by the 1966 legislation) have generated additional tax revenues for the Treasury by unlocking otherwise frozen capital gains. States that, for example, two corporate exchange funds formed in 1961 and 1964, with securities totaling $87.5 million, have realized capital gains of $25.7 million through 1975, on which $6.8 million in capital gains taxes were due.

(2) Request a grandfather rule to protect their reliance on present law up to the introduction of H.R. 11920. The joint proposal of these

three funds would except from the restrictions on swap funds a partnership which:

(*a*) Filed a registration statement with the SEC (if one was required) before February 17, 1976; and

(*b*) Filed a tax ruling request before February 17, 1976; and

(*c*) Completes exchanges of stocks deposited with the fund before February 29, 1976, or within 90 days beginning on the date of enactment of the new legislation.

Argue that no dollar limitation on the total size of a fund's portfolio should be imposed in view of the short deposit period and the fact that all funds will be competing with each other.

Equity Exchange Fund, represented by John E. Hempstead, partner, Butcher & Singer

Argues that the Equity Exchange Fund should be included in any grandfather clause adopted for swap funds since, by the date when H.R. 11920 was introduced (February 17, 1976), the organizers of this fund had spent considerable time, effort and money planning to convert the partnership (which had previously obtained a favorable tax ruling on its tax status as a partnership) into an exchange fund. Before February 17, 1976, the organizers had met with their tax counsel and had met several times with the Wellington Management Company to discuss retaining that company to manage the fund. A tax ruling request on the swap fund issue was filed on March 26, 1976. Asks that a grandfather clause protect funds which had submitted a ruling request by the committee's hearing date.

Chestnut Street Exchange Fund, represented by Richard M. Somers, Jr.

(1) Opposes the partnership swap fund provisions of the bill. Argues that both corporate and partnership exchange funds should be allowed because they unlock frozen capital gains and produce tax revenues which the Treasury would not otherwise collect.

(2) Recommends that, if the swap fund restrictions are enacted, at least funds which were in the process of being formed when the bill was introduced should be grandfathered. Also recommends a broader grandfather rule similar to the transitional rule for corporate exchange funds: a future date (e.g., May 1, 1976) should be set within which new partnership funds could register, provided solicitations and exchanges are completed within a stated period (e.g., the end of 1976).

Boston Company Financial Strategies, Inc., represented by Edward I. Rudman, President

(1) Requests inclusion of the Boston Company Exchange Associates, a privately formed partnership swap fund, in any grandfather rule adopted by the committee. States that planning for this fund began in October 1975, after the IRS ruling to Vance, Sanders became widely circulated, and that the fund filed a ruling request on February 3, 1976. States that over $25,000 of estimated out-of-pocket expenses were incurred before February 17, 1976. States further that this exchange fund is being formed as only part of overall planning for wealthy private clients and that, in planning overall diversification for such clients, the managers will recommend not only joining an exchange fund but also making taxable sales of other securities.

(2) Recommends that private funds also be allowed at least 90 days after enactment in which to receive deposits, or that private funds be allowed to make a continuing offering limited to no more than 35 participants.

B. Mergers of investment companies (including merger of personal holding companies into mutual funds)

Investment Company Institute, represented by Robert C. Augenblick, president

(1) Opposes the provision of the bill which would operate to deny tax-free treatment to reorganizations solely involving regulated investment companies, and possibly also mergers of real estate investment trusts. Points out that such mutual funds are governed by specific tax requirements which require a broadly diversified portfolio, so that such mergers do not occur in order to achieve diversification. Such mergers in fact occur for legitimate business reasons.

(2) Although relatively few mergers appear to have occurred where a conventional mutual fund acquired an undiversified personal holding company, the committee might limit any restrictions by making taxable only reorganizations involving a company which owns any security constituting over 35 percent of the value of all its assets or, alternatively, a company which does not satisfy the diversification requirements for a regulated investment company.[13]

(3) The bill presently seems broad enough to deny tax-free treatment to mergers of a family-owned or closely-held investment company with an operating business company. However, no abuse seems present in such situations.

First Fund of Virginia, Inc.; Investors Income Fund, Inc., represented by George H. Parsons, counsel

(1) States that these two funds are publicly held regulated investment companies which are planning to merge with two other publicly-held investment companies. On December 16, 1975, the directors of the above funds approved the proposed reorganization in principle and the agreement will be submitted to shareholders of both funds at their meeting in May of this year.

(2) States that no tax abuse exists in the proposed transaction and recommends that the bill not deny tax-free treatment to reorganizations involving only regulated investment companies governed by section 851 of existing law. Also argues that any restrictions on such mergers should at least not apply retroactively to February 17, 1976.

Calvin Bullock, Ltd., represented by Martin H. Proyect, Executive Vice President

(1) Recommends deleting from the bill the rule which would operate to tax reorganizations where two or more publicly owned mutual funds merge with each other. Argues that for investment reasons a profitable mutual fund will not acquire another public fund chiefly to benefit from large unrealized capital losses. States that few, if any, mergers have actually occurred for this reason. Points out that

[13] Under these tests, in general (sec. 851(b)), at least 50 percent of the value of all the assets must consist of cash or Government securities and other securities no one of which constitutes over 5 percent of the fund's assets. In any case, no more than 25 percent of the fund's assets (by value) may be invested in the securities of any one company.

such mergers ordinarily occur for legitimate business reasons and, in fact, are encouraged by the securities laws.

(2) Recommends narrowing the scope of the bill as it would affect mergers of a personal holding company into a conventional mutual fund. Points out that many private investment companies are already well diversified but may seek mergers for estate planning and other bona fide business reasons. Recommends that if any mergers in this area are to be restricted, the new rules apply only to a personal holding company which has been in operation for less than one year and which has an undiversified portfolio. (For this purpose, the test of diversity would be the same as the rules for regulated investment companies under the code.)

Growth Fund of America, Inc. and Income Fund of America, Inc., represented by Gordon D. Henderson, counsel

Recommends that the bill not make mergers of one diversified public investment company into another taxable. States that before February 17, 1976, these two funds had planned to merge with two other public funds on May 31 and July 31, 1976, respectively. The purpose of the mergers is to eliminate duplications in expense and to achieve economies of scale. Although the merger will create additional diversification in the funds' portfolios, this is not the purpose of the transaction since each separate portfolio is already broadly diversified. Although the funds being merged do have realized loss carryovers, so do the acquiring funds and, in any case, this is not a reason for the merger. States that in his experience as a securities lawyer (including prior service at the SEC), there is no trafficking in losses in the mutual fund industry.

Southeastern Capital Corporation; Phoenix, Inc., represented by Mac Asbill, Jr., counsel

Asks for an appropriate grandfather clause for the rule which would tax a merger of a personal holding company with a publicly held mutual fund. States that Phoenix (a personal holding company) plans to merge with Southeastern (a nondiversified publicly held investment company). The Service issued a private ruling on April 8, 1974, approving tax-free treatment for the proposed reorganization and, after the proposed form of the transaction was changed, again ruled favorably on August 8, 1975, on a revised format. The revised agreement of merger had been entered into on April 23, 1975. The closing was delayed, however, beyond the end of 1975 for business and securities reasons. (In particular, Southeastern found it necessary to dispose of one of its major investment assets before the merger could occur). The new closing date is planned for a date after the introduction of H.R. 11920.

C. General witnesses

Taxation with Representation, represented by Thomas J. Reese

(1) Supports H.R. 11920, particularly the provision denying tax-free treatment on formation of a swap fund.

(2) Opposes any grandfather rules for existing exchange funds, including the Vance, Sanders fund. Points out that no investors will be retroactively taxed by the effective date of the bill, since no final transfers to any fund (including Vance, Sanders) have yet occurred. Investors can be given back their stocks without any tax liability on their part. If allowance must be made for the costs incurred by brokers and organizers to date, the Treasury would save revenue if it directly reimbursed these costs rather than allowing one or more existing funds to be totally exempted.

(3) States that the IRS ruling issued to Vance, Sanders indicates how private rulings issued without advance public consultation can set dangerous precedents.

Frederic G. Corneel, Esq. (for himself)

(1) Opposes the effect of the bill to tax mergers of two conventional mutual funds because most such mergers occur for legitimate business reasons such as reducing costs, achieving a size needed for efficient operation, or changing management.

(2) Opposes as overly broad the rule in the bill which would tax all reorganizations of a personal holding company with a public mutual fund. Suggests that if the bill seeks to deny tax-free diversification, a line should be drawn under which tax-free treatment would continue available if the personal holding company was sufficiently diversified before the merger (such as meeting the diversity rules applicable to a public mutual fund). An undiversified personal holding company would then not be allowed to merge tax-free with a mutual fund.

(3) Argues that if transfers to partnerships are to be taxable where diversification occurs, the bill should specifically define the type of partnership affected and limit the new rule to partnerships having more than 35 members. Otherwise, the bill could adversely affect neighborhood investment clubs and family partnerships where no abuse apparently exists.

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