

Exchange Funds

An exchange fund allows investors holding a large concentrated position in an individual equity to diversify their exposures without incurring immediate tax liabilities. You invest in an exchange fund by contributing equity securities (from an approved list); in return, you receive shares of interest in the fund. An exchange fund allows you to diversify your exposure from a single stock to a more broadly diversified portfolio, while allowing continued deference of capital gain tax liabilities.

Exchange funds (also known as “swap” funds) have been in existence for over 40 years and are protected by a provision in the tax code (IRS Code section 721) that allows exchanges provided the partnership (or fund) holds no more than 80% of its assets in “stock and securities.” At least 20% of the fund’s assets must be held in “Qualifying Assets,” which consist of a limited range of less liquid investments. To meet this requirement, exchange funds typically invest in direct real estate or real estate related securities issued by operating partnerships.

HOW DO I KNOW IF AN EXCHANGE FUND IS RIGHT FOR ME?

Exchange funds offered through RBC Wealth Management are offered as private placements. A private placement investment is offered to sophisticated investors; the product is not registered with the Securities and Exchange Commission (SEC), and the securities it issues do not trade in a secondary market. This means that when you want to redeem your shares, you must do so through the exchange fund. Only accredited investors and qualified purchasers with a minimum of \$5 million in investable assets may purchase shares in these exchange funds.

Important information relating to the investment, including a detailed description of the investment strategy, the fees and risks associated with the investment, and the terms for the purchases in and redemptions from the exchange fund, are in the investment’s private placement memorandum. You should read this document thoroughly before investing in the fund.

PROFESSIONAL MANAGEMENT

The fund managers maintain a select list of securities that they will accept based on current fund holdings and the investment mandate that is disclosed in the private placement memorandum of the fund. Generally, equity securities must have a minimum market capitalization of at least \$250 million and be listed on a major exchange to be eligible for consideration by the fund.

HOW CAN I INVEST WITHOUT INCURRING CAPITAL GAINS?

As previously described, to allow the exchange of contributed securities for fund shares to be non-taxable, the fund must invest in certain “Qualifying Assets.” These qualifying assets must make up at least 20% of the assets of the fund and generally consist of real estate-related investments and transactions. The fund usually acquires these assets by borrowing against the value of the fund. In other words, the fund uses leverage to purchase real estate investments, which are typically illiquid as they consist of investments directly in properties or real estate related securities. The remaining 80% of the fund’s assets consist of securities exchanged by shareholders. Consult the fund’s private placement memorandum to learn more about the applicable tax code and treasury regulations that govern these offerings.



RBC Wealth Management®

Exchange Funds, continued

THE PURCHASE PROCESS

If you wish to invest in an exchange fund, you must complete the fund's subscriptions document. Exchanges into the fund are accepted a limited number of times each year, as determined by each fund. The fund collects the subscription documents and determines whether it will accept the stock offered; the fund may limit the amount of any security it chooses to accept, allowing it to adhere to the fund's investment mandate. You will have the opportunity to review the portfolio prior to finalizing your exchange into the fund.

RISKS ASSOCIATED WITH EXCHANGE FUNDS

As with any investment, there are risks:

- Fund may make income distributions to shareholders, which are taxable;
- Investment risks associated with the investment strategy employed by the fund;
- As a private placement, tax reporting is completed via a K-1 document, and not a 1099. This could impact your tax filing deadline, and require that you file an extension.
- Liquidity risk, or the risk that investors redeeming shares results in the forced sale of illiquid assets. In addition, the lack of a secondary market and holding period restrictions may limit your ability to redeem shares prior to a stated time period.
- Leverage risk, or the Fund's use of debt financing for the purchase of illiquid real estate properties or real estate related securities. In addition, the equity securities used as collateral to obtain debt financing may decline in value and thus require the forced sale of illiquid investments.

- Credit risk, or the inability of major tenants to meet lease agreements may affect the value of individual properties held by the fund.
- Regulatory risk, or concerns that IRS tax code provisions could change to the Fund's detriment.

ACCESSING YOUR INVESTMENT

The private placement memorandum outlines how you redeem shares from the fund. Generally, redemptions made within a specified holding period will be met by returning to you the securities you contributed to the fund, at the original or adjusted tax basis, depending on how the product is structured. You may also receive other securities including cash, from the fund, depending on the amount of the redemption. You will not pay capital gains on the redemption until you sell the securities received as redemption proceeds from the fund.

ESTATE TAX BENEFITS

If your shares in an exchange fund become part of your taxable estate, they generally will receive a step up in tax basis to their value as of the date of death or six months thereafter, eliminating potential tax liability for accrued capital gains.

TO FIND OUT MORE

Contact your RBC Wealth Management® Financial Advisor to learn more about exchange funds. You should also consult your tax advisor and attorney to determine if an exchange fund is appropriate for your financial situation.

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