The Investment Company Exception to Sections 351 and 721 Needs Clarification, But Legislative Proposals May Add to the Confusion by Expanding the Reach of the Investment Company Rules

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Section 351(a), which generally provides for non-recognition of gain or loss on the transfer of property to a corporation which is controlled by the transferors immediately after the transfer, does not apply to the transfer of property to an investment company.[1] *As a result, a transferor recognizes gain or loss in connection with the contribution of property to an investment company.*

Section 721(a) is the partnership analog to Section 351(a). Section 721(b) provides that the general rule of non-recognition for contribution of property to a partnership does not apply to gain realized on the transfer of property to a partnership that would be treated as an investment company were it a corporation.[2]

The term "investment company" is not defined in the Code. The meaning of "investment company" must be developed from a careful reading of the regulations and the application of Section 351(e)(1), which contains a lengthy list of assets that are treated as stock or securities for purposes of making the investment company determination.

Evolution of the Investment Company Rules

The predecessor of Section 351(e) was enacted in 1966.[3] The purpose of the provision was to combat the use of corporate swap funds whereby

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[1] Section 351(e).

[2] It should be noted that unlike Section 351(e), Section 721(b) only applies to gain, meaning that the general non-recognition rule of Section 721(a) would apply on the transfer of loss property to a partnership swap fund.

[3] Foreign Investors Tax Act of 1966, PL 89-809, § 203.

groups of investors would transfer appreciated stocks and securities to a newly formed corporation in return for shares in that corporation.[4] Until 1966, swap funds provided investors with a means to achieve diversification without recognizing gain.

Although "investment company" was not and still is not defined in the Code, in 1967 the Treasury adopted regulations to provide guidance in the area.[5] In addition to defining "investment company," the regulations, which will be discussed below, added the diversification requirement.

At the time of enactment of the predecessor of Section 351(e), swap funds were generally not structured as partnerships due to securities law restrictions and to problems with state partnership laws.[6] Subsequent changes in state partnership laws, however, encouraged the formation of swap funds structured as partnerships. In 1975, the IRS issued a favorable private ruling allowing the tax-free exchange of securities for interests in a partnership.[7] As a result of these circumstances, the Tax Reform Act of 1976 modified Section 721 to mandate recognition of gain on transfers of property to a partnership that would be treated as an investment company if the partnership were incorporated.[8]

Regulation Section 1.351-1(c) was amended in 1996 to provide that a transfer will not result in diversification if each transferor transfers a diversified portfolio of stocks and securities.[9] The reasoning behind the addition of the diversified portfolio exception was that a transfer could not result in diversification if the assets transferred were already diversified.

Section 351(e) was itself amended as part of the Taxpayer Relief Act of 1997.[10] Congress was once again concerned with the appearance of swap funds holding more than 80% of their assets in "high-quality investment assets … such as non-convertible debt instruments, notional principal contracts, foreign currency and interests in metals."[11] As a result of this concern, the types of assets that will lead to classification of a transferee as an investment company was greatly expanded. Prior to the amendment of Section 351(e), the regulations only accounted for "readily marketable stocks and securities" in making the investment company de-

[4] For a general discussion of the history of swap funds, see H. Rep. No. 1049, 94th Cong., 2d Sess. (April 27, 1976).

[5] TD 6942, 1968-1 CB 136.

[6] H. Rep. No. 1049 at 7.

[7] Id. See PLR 7504280550A (April 28, 1975).

[8] PL 94-455, § 2131.

[9] Reg. 1.351-1(c)(6), TD 8663, 1996-1 CB 34.

[10] PL 105-34, § 1002.

[11] Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (1997 Blue Book), December 17, 1997, p. 183.

termination. The 1997 amendment to Section 351(e) was intended to expand the types of assets considered in making the investment company determination under the regulations, but not to override the other provisions of those regulations.[12] For example, that Act does not override:

- The requirement that only assets held for investment are considered for purposes of making the investment company determination.
- The rule treating the assets of a subsidiary as owned proportionately by a parent entity owning 50% or more of the subsidiary's stock.
- The requirement that the investment company determination consider any plan with regard to an entity's assets in existence at the time of transfer.
- The requirement that a contribution of property to an investment company result in diversification in order for gain to be recognized.[13]

Investment Company Defined

Prior to the Taxpayer Relief Act of 1997, an investment company was defined by the regulations as either a regulated investment company (RIC), a real estate investment trust (REIT) or a corporation more than 80% of the assets of which, measured by value (excluding cash and nonconvertible debt obligations), are held for investment and are readily marketable stocks or securities, or interests in RICs or REITs.[14]

While the regulations were never changed, as described above, the amendments to Section 351(e) contained in the Taxpayer Relief Act of 1997 significantly expanded the types of assets that are taken into account in testing whether a transferee is an investment company. The list of assets contained in Sections 351(e)(1)(A) and (B) presently includes:

1. All stock and securities held by the company.
2. Money.
3. Stock and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives.
4. Any foreign currency.
5. Any interest in a REIT, a common trust fund, a RIC, a publicly traded partnership (as defined in Section 7704(b)) or any other equity interest (other than in a corporation) that, pursuant to its

[12] Id. at 184.

[13] Id.

[14] Reg. 1.351-1(c)(1)(ii).

terms or any other arrangement, is readily convertible into, or exchangeable for, any asset described above.

6. Except to the extent provided in regulations, any interest in a precious metal, unless the metal is used or held in the active conduct of a trade or business after the contribution.
7. Except as provided in regulations, any interests in any entity if substantially all the assets of the entity consist (directly or indirectly) of any assets described above. For these purposes, the term "substantially all" is construed to have the same meaning as under Section 731(c)(2) and Reg. 1.731-2(c)(3)(i). Thus, an entity meets the substantially all test if 90% or more of its assets are listed assets. In addition, in the case of partnerships and other unincorporated entities, where 20% or more (but less than 90%) of the entity's assets consist of listed assets, a proportionate interest in the entity will be treated as a listed asset.[15]
8. To the extent provided in regulations, an interest in any entity not described in 7 above, but only to the extent the value of such an interest derives from assets described above.
9. Any other asset specified in regulations.

Look-through Rule for Ownership of Stock in Subsidiaries.

Regulation Section 1.351-1(c)(4) provides a look-through rule whereby, if the requisite ownership test is met, a corporation is deemed to own a ratable share of its subsidiary's assets. The regulation provides that a corporation will be considered a subsidiary if the parent owns 50% or more of either the combined voting power of all classes of stock entitled to vote, or the total value of shares of all classes of stock outstanding. Thus, a corporation otherwise classified as an investment company may escape such classification if it holds a sufficient amount of stock in a corporation holding operating assets and other assets not listed under Section 351(e)(1).[16]

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[15] Reg. 1.731-2(c)(3)(ii). S. Rep. No. 33, 105th Cong., 1st Sess. (June 20, 1997), n. 69. See also 1997 Blue Book, p. 184, n. 204.

[16] How does the look-through rule apply for an investment partnership that owns more than 50% of the stock in a corporation (interests in partnerships are covered below)? The language of Reg. 1.351-1(c)(4) only mentions stock and securities in subsidiary corporations owned by a "parent corporation" and fails to mention partnership shareholders. Does this omission mean that partnerships may not avail themselves of the look-through rule? Not according to the 1997 Blue Book, which states that "the [Taxpayer Relief] Act also did not override the rule, that for purposes of determining whether a corporation or partnership is an investment company, the assets of a corporation are treated as owned proportionally by any shareholder (whether a corporation or other entity) owning 50% or more of its stock." 1997 Blue Book, p. 184. See also PLR 200211017 (December 12, 2001).

Ownership of Interests in Partnerships.

The look-through rule of Reg. 1.351-1(c)(4) specifically deals with stock in subsidiary corporations. Is there a look-through rule for interests in lower-tier partnerships? According to at least one commentator, without additional guidance on this matter, a taxpayer could not rely on such a look-through rule to have a sufficient amount of non-listed assets so as to avoid classification as an investment partnership.[17] As described above, a partnership interest will be a listed asset in two situations:

1. Where the partnership has at least 20% but less than 90% listed assets, a pro rata portion of the partnership interest will be a listed asset.
2. Where the partnership has 90% or more listed assets, the entire partnership interest will be a listed asset.

Accordingly, until additional guidance is issued, a corporation or partnership being tested for investment company status probably should apply the look-through rule only where its application does not benefit the parent entity in its investment company calculation.

Effect of Subsequent Transfers on Investment Company Determination

According to Reg. 1.351-1(c)(2), the investment company test is ordinarily applied immediately after the transfer in question. The regulation also provides that where, pursuant to a preexisting plan, circumstances change, the determination will be made based on the later circumstances. These later circumstances could include the acquisition of unlisted assets, as explained in the legislative history of Taxpayer Relief Act of 1997:

> Although money is counted toward the 80-percent test under the bill, this provision in the regulations should have the effect that where money is contributed and, pursuant to a plan, assets not treated as stock or securities under the bill are either purchased or contributed by other parties, the investment company determination would be made only on the basis of the entity's assets after such events.[18]

Diversification Requirement

In addition to the requirement that there be a transfer of property to an investment company, the regulations also require that the transfer must

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[17] Chester W. Grudzinski, "Property Contributions to Partnerships More Likely to Result in Gain After TRA '97," 15 J. Partnership Tax'n 291, 298 (1999).

[18] S. Rep. No. 105-33, p. 132, n. 70 (1997).

result, directly or indirectly, in the diversification of the transferors' assets (the "diversification test").[19] The test is ordinarily satisfied if two or more persons contribute non-identical assets to the corporation or partnership.[20] It is not entirely clear how the phrase "non-identical" will be interpreted.[21]

Regulation 1.351-1(c)(5) contains an exception to the prohibition on the transfer of non-identical assets, providing that if the value of the non-identical assets is "insignificant" as compared to the total value of the assets transferred, the transfer of non-identical assets will be disregarded in making the determination of whether diversification has occurred. The only example on this issue in the regulation treats a contribution of a non-identical asset that is less than 1% of the total value of all contributed assets as insignificant.[22] In a 1999 letter ruling, the IRS ruled that a transfer including non-identical assets not in excess of 5% of the aggregate value of all assets was insignificant for purposes of Reg. 1.351-1(c)(5).[23] On the other end of the spectrum, the IRS ruled that a transfer of cash representing 11% of the total value of the assets transferred (where the only other asset transferred was stock in a single corporation) was not an insignificant portion of the total value of the transferred assets. [24]

Regulation 1.351-1(c)(5) also contains an exception in cases where there is only one transferor to a newly organized corporation. According to the regulation, such transfers will generally not result in diversification.

Effect of Subsequent Transfers on the Diversification Requirement

In addition to accounting for subsequent transfers of assets pursuant to preexisting plans in making the investment company determination, the regulations provide a similar rule in testing for diversification. Specifically, the regulations provide that if a transfer is:

> part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for

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[19] Reg. 1.351-1(c)(1)(i).

[20] Reg. 1.351-1(c)(5).

[21] See, e.g., Monte A. Jackel and James B. Sowell, "*Transfers to Investment Companies: Complexity in a Conundrum*," 94 Tax Notes 1659 (2002) (suggesting that 'non-identical' be interpreted in accordance with strict standards due to the availability of the diversified portfolio exception and the insignificant portion exception).

[22] Reg. 1.351-1(c)(7) Example 1.

[23] PLR 200006008 (September 30, 1999). See also PLRs 199901028 (October 13, 1998) and 9751048 (August 28, 1997). For an extensive discussion of the insignificant portion exception, see Jackel and Sowell, *supra* note 21, at 1674.

[24] Rev. Rul. 87-9, 1987-1 CB 133.

> nonrecognition treatment, the original transfer will be treated as resulting in diversification.[25]

It is important to note the inclusion of the phrase "without recognition of gain" in the regulations quoted above. Apparently, if a transferee corporation sells the transferred assets and acquires new assets that result in diversification, the initial transfer is not a transfer to an investment company because it is not part of a plan to achieve diversification in a series of nonrecognition transactions.[26]

Exception for Transfer of a Diversified Portfolio

Regulation 1.351-1(c)(6)(i) provides that if each transferor transfers a "diversified portfolio of stocks and securities," the transfer will not result in diversification for purposes of Reg. 1.351-1(c)(5). The regulation provides that whether a portfolio of stocks and securities is diversified is tested under Section 368(a)(2)(F)(ii). That section deals with reorganizations (other than recapitalizations) involving two or more investment companies. The definition of "investment company" is provided in Section 368(a)(2)(F)(iii). *For Section 368 purposes,* an investment company is a RIC, a REIT, or a corporation 50% or more of the value of whose total assets are stock and securities and 80% or more of the value of whose total assets are assets held for investment. In general, unless an investment company meets the diversification requirements of Section 368(a)(2)(F)(ii), reorganization treatment will not be accorded to such an investment company (and its shareholders and security holders).

Section 368(a)(2)(F)(ii) provides that the diversification requirements are met if not more than 25% of the value of the corporation's total assets are invested in stock or securities of one issuer and not more than 50% of the value of its total assets are invested in the stock of five or fewer issuers. For purposes of this 25/50 test, members of a controlled group of corporations (as defined in Section 1563(a)) are treated as a single issuer. Section 368(a)(2)(F)(ii) also provides a look-through rule whereby a person holding stock in a RIC, a REIT, or an investment company that meets the requirements of that section will be treated as owning its proportionate share of the assets held by such company or trust.

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[25] Reg. 1.351-1(c)(5).

[26] Rev. Rul. 88-32, 1988-1 CB 113. See also, Ltr. Rul. 9544012 (August 1, 1995) (transfer of cash to a partnership followed by a transfer of marketable securities to the partnership did not result in diversification. The IRS noted that although the potential for diversification via the purchase of other investments existed, because such diversification would not occur in a nonrecognition transaction, the initial transfers of cash and securities were not treated as diversifying the transferees interests).

Section 368(a)(2)(F)(iv) provides that in making the investment company determination, cash, receivables, government securities, and, under regulations prescribed by the IRS, assets acquired (through incurring indebtedness or otherwise) for purposes of meeting the diversification requirement of Section 368(a)(2)(F)(ii) will be disregarded. The 25/50 test is modified by Reg. 1.351-1(c)(6)(i) so that government securities are included in the denominator (they are included as assets) but are excluded from the numerator (they are not treated as securities of an issuer). These modifications do not apply if the government securities were acquired for purposes of meeting the 25/50 tests.

Effect of Transfer of Cash in Addition to Diversified Portfolio

Regulation 1.351-1(c)(6)(i) specifically mentions a diversified portfolio of stocks and securities. What if, in addition to a diversified portfolio, the transferor also transfers cash? The IRS has ruled that when transferors transfer diversified investment portfolios (meeting the requirements of Section 368(a)(2)(F)(ii)) and cash, the cash transfer will not result in diversification for purposes of Reg. 1.351-1(c)(6).[27]

Effect of Transfer of Partnership Interest

In two 1999 private letter rulings, the IRS ruled that the transfer of partnership interests to a newly created partnership satisfied the diversified portfolio exception where substantially all of the underlying partnership's assets consisted of a diversified portfolio of stock and securities.[28]

Special Issues Arising in Transfers to REITs

A transfer will be considered a transfer to an investment company if (1) the transferee is a RIC, a REIT, or a corporation more than 80% of the value of the assets of which, measured by value, are stocks, securities, and certain other listed assets, and (2) the transfer "results, directly or indirectly, in diversification of the transferors' interests."[29] Therefore, the transfer of real property to a REIT in a transaction otherwise described in Section 351(a) generally will be taxable unless the transfer does not result in diversification of the transferors' interests.

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[27] PLRs 200025012 (March 17, 2000), 200008025 (February 4, 2000), 199925017 (March 22, 1999), 199909045 (November 30, 1998) (transfer of diversified portfolio of assets to fund qualified as tax-free transfer under Section 721 notwithstanding plan to market interests to new investors for cash). See also "Cash is a Diversified Asset for 721(b) Investment Company Determination," 92 J Tax'n 3 (May 2000).

[28] PLRs 199917049 (May 10, 1999), and 19917050 (May 10, 1999).

[29] Reg. 1.351-1(c)(1).

Diversified Portfolio Exception as Applied to REITs

As with transfers to investment companies in general, a transfer of a diversified portfolio of real estate to a REIT should not result in diversification of the transferors' interests and, therefore, should not be considered a transfer to an investment company.[30] There is no authority directly addressing when a portfolio of real property should be considered diversified for this purpose (or even the factors that should be taken into consideration in making this determination).

Impact of a Public Offering of REIT Shares for Cash

A public offering of REIT shares for cash in connection with the contribution of a portfolio of real property that is not diversified may render the contribution of real property taxable. Such an offering should not, however, cause a contribution of *diversified* portfolios of real property to be taxable regardless of the use of such cash. In other words, cash should not "result" in diversification if the transferors' interests are already diversified.

There are a number of private rulings addressing the impact of Section 351(e) on contributions to REITs.[31] PLR 199915030 specifically states that Section 351(a) applies regardless of whether the REIT undertakes a public offering without limiting the use of the cash by the REIT. PLR 9801016 sets forth factors that appear to indicate the real property was diversified, but limits the REIT's use of cash in connection with a simultaneous public offering to the repayment of debt or the acquisition of assets under the predecessor partnership's business plan. PLR 199947001, on the other hand, sidesteps the issue by representing that the REIT has no plan to issue stock (although it does indicate the REIT will issue stock if "conditions are favorable.").

Proposed Legislation

Although the amendments to Section 351(e) enacted as part of the Taxpayer Relief Act of 1997 were intended to restrict the use of swap funds, recent proposals suggest that additional changes may be forthcoming.

Neal Bill

Legislation was originally proposed on August 4, 1999, by Representative Neal (Dem.-Mass.) (the "First Neal Bill").[32] The proposed legislation had

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[30] Reg. 1.351-1(c)(6)(i). See also PLR 199915030 (January 12, 1999).

[31] PLRs 9744003 (July 15, 1997), 9801016 (September 30, 1997), 199915030 (above, n. 30), and 199947001 (December 7, 1998).

[32] H.R. 2705, 106th Cong. (1999).

two components. It sought to eliminate the use of preferred partnership interests as unlisted assets for purposes of Section 351(e) by amending Section 351(e)(1)(B) to include such interests as listed assets. In addition, the First Neal Bill sought to add a new Section 351(e)(3) that would significantly broaden the reach of Section 351(e) by taxing transfers of property (defined as Section 731(c)(2) marketable securities) to certain corporations, regardless of the amount of listed and non-listed assets held by the transferee. Transferees identified in the legislation are:

- A corporation registered under the Investment Company Act of 1940 (the Act).
- A corporation exempt from registration under the Act because interests in the corporation are offered to qualified purchasers (within the meaning of the Act).
- A corporation formed or availed of for the purpose of allowing persons with significant blocks of marketable securities with unrealized appreciation to diversify those holdings without recognition of gain.

The First Neal Bill also contained a provision to amend Section 721(b) to apply Section 351(e)(3) to partnerships.[33]

Representative Neal introduced substantially similar legislation in the 107th Congress (the "Second Neal Bill").[34] As was the case with the First Neal Bill, the Second Neal Bill would add preferred partnership interests as a listed asset in Section 351(e)(1)(B). The Second Neal Bill contains a slightly different version of proposed Section 351(e)(3), however. Specifically, the Second Neal Bill excludes the transfer of a "diversified portfolio of securities" from the reach of proposed Section 351(e)(3). In addition, proposed Section 351(e)(3)(C) requires that the transfer result, directly or indirectly, in diversification of the transferor's interest.

The proposed legislation would significantly extend the reach of the investment company rules by including preferred partnership interests as listed assets and by the addition of Section 351(e)(3), which would tax the transfer of property to certain transferees, regardless of the amount of listed

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[33] Specifically, the Section 1(c) of the Neal Bill sought to amend Section 721(b) to read as follows:

(b) SPECIAL RULE.—Subsection (a) shall not apply to gain realized on a transfer of property to a partnership if, were the partnership incorporated –

(1) such partnership would be treated as an investment company (within the meaning of section 351), or

(2) section 351 would not apply to such transfer by reason of section 351(e)(3).

[34] H.R. 2406, 107th Cong. (2001).

and non-listed assets held by such transferees. The proposed legislation also threatens to add an additional layer of uncertainty to the investment company equation by introducing the "formed or availed of" test.

Former President Clinton's Treasury Proposal

In February 2000, the administration of former President Clinton released its proposed fiscal year 2001 budget. Included in the proposals was a provision aimed at prohibiting tax deferral on the contribution of property to swap funds.[35] Like the Neal bills, the Clinton proposal would have classified preferred partnership interests as listed assets. In addition, the proposal would have required the recognition of gain on the transfer of marketable stock or securities to a corporation or partnership if the corporation or partnership was "(1) registered under the Investment Company Act of 1940 as an investment company, (2) not required to be registered under the Investment Company Act because the interests in the fund are offered only to qualified purchasers within the meaning of the Act, or (3) marketed or sold to investors as providing a means of tax-free diversification."[36] Also like the Neal bills, the Clinton proposal would have excluded transfers of diversified portfolios of stock or securities.

Conclusion

The investment company exception to Sections 351(a) and 721(a) remains difficult to apply in a number of situations. Legislative proposals, meanwhile, would expand the coverage of the investment company exception to nonrecognition and would add to the uncertainty that plagues this area. If enacted, these proposals would undoubtedly increase the need for more specific regulatory guidance.

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[35] Dept. of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals*, at 147 (Feb. 2000).

[36] Id.

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