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October 14, 1999

H =

W =

P =

Dear :

This is in response to your letter, dated May 22, 1999, written on behalf of H and W, requesting a ruling under § 721 of the Internal Revenue Code.

The information submitted provides that P is a limited partnership engaged in acquiring marketable securities for investment. H and W hold a 1 percent general partnership interest in P as community property. The remaining 99 percent partnership interest is held by H and W's three children. H and W represent that more than 80 percent of P's assets are held for investment and are readily marketable stocks or securities.

H and W propose to contribute appreciated securities to P in exchange for a limited partnership interest. H and W represent that the securities to be transferred consist of a diversified group of publicly owned securities, no one issue of which will represent more than 25 percent of the value of the total securities to be contributed, and not more than 50 percent of the value of all securities to be contributed will consist of the securities of 5 or fewer issuers. The limited partnership interest to be received by H and W in exchange for the contribution of the securities will be based on the market value of the contributed securities relative to the value of all the securities in P after the contribution.

It is further represented that after H and W's proposed contribution, the securities in P of one issuer will continue to

represent more than 25 percent of the value of its total assets and more than 50 percent of the value of all of P's assets will be invested in the stocks or securities of 5 or fewer issuers.

Section 721(a) provides that no gain or loss shall be recognized by either a partnership or its partners on the contribution of property to a partnership in exchange for an interest in the partnership. Section 721(b), however, provides that gain (but not loss) realized on such a transfer may be recognized if the partnership would be treated as an investment company within the meaning of § 351, if the partnership were incorporated.

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.

Section 351(e)(1) provides that § 351 does not apply to a transfer of property to an investment company. Section 351(e)(1) further provides that the determination of whether a company is an investment company is to be made by taking into account all stock and securities held by the company. Section 351(e)(1)(B) provides that the term stocks and securities includes stock, money, indebtedness, and other enumerated assets.

Section 1.351-1(c)(1) of the Income Tax Regulations provides that a transfer to an investment company occurs when (i) the transfer results, directly or indirectly, in diversification of the transferors' interests, and (ii) the transferee is a regulated investment company (RIC), real estate investment trust (REIT), or a corporation more than 80 percent of the value of whose assets are held for investment and are readily marketable stocks and securities, or interests in RICs or REITs.

Section 1002 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997) (the "Act"), amends section 351(e) for transfers after June 8, 1997, in taxable years ending after such date, subject to certain transitional relief provisions. Section 1002 of the Act is intended to expand the types of assets considered in determining whether a transfer is to a transferee described in § 1.351-1(c)(1)(ii)(c) to include certain assets in addition to "readily marketable stocks or securities" and interests in RICs or REITs. However, the Act is not intended to alter the requirement of § 1.351-1(c)(1)(i) that a transfer of property will be considered to be a transfer to an investment company under § 351(e) only if the transfer results, directly or indirectly, in diversification of the transferors' interests.

See S. Rep. No. 105-33, 105th Cong., 1st Sess. 131 (1997); H.R. Rep. No. 105-148, 105th Cong., 1st Sess., 447 (1997); H.R. Rep. No. 105-220, 105th Cong., 1st Sess. 516-17 (1997).

Section 1.351-1(c)(5) provides that a transfer ordinarily results in diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in the exchange. For this purpose, if any transaction involves one or more transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, such transfers shall be disregarded in determining whether diversification has occurred. If there is only one transferor (or two or more transferors of identical assets) to a newly organized corporation, the transfer will generally be treated as not resulting in diversification. Section 1.351-1(c)(5) further provides 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 nonrecognition treatment, the original transfer will be treated as resulting in diversification.

Section 1.351-1(c)(6)(i) provides that a transfer of stocks and securities will not be treated as resulting in diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities. A portfolio of stocks and securities is considered to be diversified if it satisfies the 25- and 50-percent tests of § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F), except that government securities are included in total assets for purposes of the denominator of the 25- and 50-percent tests (unless acquired to meet the 25- and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25- and 50-percent tests.

An investment company is diversified within the meaning of § 368(a)(2)(F)(ii) if not more than 25 percent of the value of its assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of 5 or fewer issuers.

After applying the law to the facts submitted and representations made, we conclude that the transfer of the diversified portfolio of stocks and securities (within the meaning of § 1.351-1(c)(6)(i)) to P by H and W would not be transfers to an investment company (within the meaning of § 351)

if P were incorporated. Accordingly, gain or loss will not be recognized on the proposed contribution of securities by H and W to P under § 721(a).

Except as specifically ruled above, we express no opinion concerning the federal tax consequences (including any estate and gift tax consequences) of the transaction described above under the cited Code provisions or any other provision of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this ruling is being sent to H and W.

Sincerely yours,

J. THOMAS HINES
Senior Technician Reviewer
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and Special
Industries)

Enclosures: 2
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