Report on Investment Company Provisions: Sections 351(e) and 368(a)(2)(F)

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Report on Investment Company Provisions:
Sections 351(e) and 368(a)(2)(F)

I. Introduction

This report of the New York State Bar Association Tax Section addresses issues that arise under sections 351(e) and 368(a)(2)(F) of the Internal Revenue Code (the "Code") (the "Report").[1] Generally, sections 351(e) and 368(a)(2)(F) deny tax-free treatment for a transaction that otherwise qualifies as a section 351 exchange or a section 368 reorganization where the transaction involves one or more "investment companies." Section 351(e) principles are adopted by reference in section 721(b), which requires gain to be recognized on the transfer of property to a partnership that would be treated as an investment company under section 351(e).[2]

The investment company provisions were enacted decades ago to eliminate taxpayers' ability to use the tax-free provisions of the Code to diversify appreciated positions in investment assets without the recognition of gain. Since that time, the Department of the Treasury (the "Treasury") and Internal Revenue Service (the "Service") have issued little formal guidance and such guidance has not been updated for subsequent modifications to the provisions. As discussed herein, opportunities to achieve the results that led to the enactment of the investment company provisions continue under current law.[3] At the same time, the investment company provisions may apply to transactions that do not implicate their policy underpinnings. This Report makes recommendations for the Treasury and Service to provide guidance that will (1) ensure the types of transactions Congress was concerned with are subject to recognition, (2) eliminate unintended applications of the provisions, and (3) provide certainty to taxpayers on significant ambiguities under current law.[4] The Report does not make recommendations for possible statutory amendments.

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[1] The drafters of this Report were Karen Gilbreath Sowell, Mike Kaibni, Rachel Kleinberg and Raymond Stahl. Helpful comments were received from Peter Blessing, Dale Collinson, Pamela Fuller, Alan Kravitz, Vadim Mahmoudov, Omri Marian, William Oates, Debbie Paul, Michael Schler, David Schnabel, Joel Scharfstein, Peter Schuur, Jodi J. Schwartz and Willard Taylor. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] Section 351(e) principles are also adopted in section 683, which generally requires gain to be recognized on the transfer of property to a trust in exchange for an interest in other trust property if the trust would be treated as an investment company under section 351(e). An exception is provided for pooled income funds within the meaning of section 642(c)(5). In addition, section 584(h)(4) provides that the nonrecognition treatment that results under section 584(h), if a common trust fund transfers substantially all of its assets to a regulated investment company, will not apply to any common trust fund that would not meet the requirements of section 368(a)(2)(F)(ii) if it were a corporation. Sections 351(e), 368(a)(2)(F), 584(h)(4), 683, and 721(b) are referred to herein as the "investment company provisions."

[3] *See*, *e.g.*, The New York Times, September 10, 2002, Johnson, "A Tax Break for the Rich Who Can Keep a Secret"; Herzig, "Am I the Only Person Paying Taxes? The Largest Tax Loophole for the Rich – Exchange Funds," 2009 Mich. St. L. Rev. 503 (2009) (discussing among other things the use of preferred interests in UpREIT partnerships to ensure the partnership is not an investment company).

[4] While the recommendations in this Report related to section 351(e) would, if adopted, be relevant to sections 721(b) and 683 as a result of the congressional cross-reference, this Report does not make any recommendations

(footnote continued)

Part II of the Report summarizes our principal recommendations. Part III is a background section reviewing the statutory language of sections 351(e), 368(a)(2)(F) and 721(b), the regulations under section 351(e), the proposed regulations under section 368(a)(2)(F) that were withdrawn in 1998, and relevant administrative guidance. Part IV describes and illustrates our recommendations.

II. Summary of Principal Recommendations

A. Section 351(e) – Investment Company

- ***Scope of Listed Investment Assets.*** Because Listed Investment Assets is an incomplete list of assets that are held for investment, a majority of the Tax Section recommends the adoption of the section 368(a)(2)(F) concept of "investment assets" and treat any asset held for investment as a Listed Investment Asset. A substantial minority believes such an expansion should be within the purview of Congress.

- ***Treatment of cash as a Listed Investment Asset.*** When substantially all the property transferred is not Listed Investment Assets, there should be a presumption that cash is not a Listed Investment Asset, unless there is a plan to invest the cash in other Listed Investment Assets.

- ***Look-through rules.*** Ownership of subsidiary stock by related entities should be aggregated for purposes of the Section 351(e) Look-Through Rule. If the Treasury and Service believe it is administrable, a pure look-through rule should be adopted for partnerships or other non-corporate entities so that only the portion of the entity's interest, based on the percentage of underlying Listed Investment Assets, would be treated as a Listed Investment Asset.

B. Section 351(e) – Diversification Test

- ***Effect of diversification on other transferors.*** If more than one transferor transfers property to a Section 351(e) Investment Company and one such transferor achieves diversification, the other transferor(s) should receive nonrecognition treatment, regardless of whether the non-diversifying transferor(s) satisfy the section 368(c) "control" test.

- ***Treatment of cash for Section 351(e) Diversification Test.*** Published guidance should confirm that (i) a transfer of cash will not be treated as a diversifying transfer that causes otherwise qualifying transfers of

(footnote continued)

specific to these provisions. Similarly, the recommendations in this Report related to section 368(a)(2)(F) would, if adopted, be relevant to section 584(h)(4), and no special recommendations are made in this Report. We note it may be appropriate to deviate from the proposals made in the Report to accommodate the policy considerations for these special sections.

diversified portfolios to be taxable, and (ii) cash will not be treated as a transfer of a non-identical asset if the cash is intended to be used (and is used) to acquire assets identical to those contributed by other transferors.

- ***Transferor attribution rule.*** For purposes of the Section 351(e) Diversification Test, an attribution rule should be adopted that would treat a transferor as owning another transferor's assets if they are related.

- ***Government securities.*** The acquisition of government securities by a transferor in order to satisfy the Section 368(a)(2)(F) 25/50 Test prior to a transfer should be permissible.

- ***De Minimis Test.*** The Transferor Specific Methodology or PLR Methodology should be used to determine whether an "insignificant portion" of the total value of assets transferred involves the transfer of non-identical assets.

- ***Transfers to oldcos.*** A transferor's direct interest in the assets transferred as well as the indirect interest in the transferee corporation's assets should be compared before and after the transfer to determine whether diversification has resulted. In determining the indirect interest in the assets, a look-through rule should be adopted for entities owned by the transferee corporation. If, before the transfer, the combination of the assets to be transferred and the transferor's pro rata share of the assets held by the transferee would constitute a diversified portfolio, the transfer should not result in diversification.

C. Section 368(a)(2)(F)

- ***Section 368(a)(2)(F) Investment Company Look-Through Rule.*** The attribution rules that are adopted for the Section 351(e) Look-Through Rule should be adopted for Section 368(a)(2)(F).

- ***Section 368(a)(2)(F) Diversification Look-Through Rule.*** A look-through rule for 50 percent or greater owned corporate subsidiaries should apply for purposes of determining whether an investment company is diversified.

- ***Common Control Exception.*** An attribution rule should be provided for applying the Common Control Exception. In addition, guidance should be provided for determining permitted variances in stock ownership.

III. Background

Section 351(e) was enacted in 1966 to prevent investors from transferring appreciated marketable stocks and securities to newly formed investment companies, referred to as "exchange funds" or "swap funds", on a tax-free basis.[5] Prior to the enactment of section 351(e), in a typical exchange fund transaction, a professional investment manager brought together investors who each held appreciated stock of a single, but different, issuer.[6] The investors contributed their respective holdings to a newly formed corporation in exchange for shares pursuant to section 351,[7] enabling the investors to diversify their appreciated investment assets without the recognition of gain.[8] Congress responded to the proliferation of exchange fund transactions with the enactment of section 351(e).[9]

Ten years later, after it became apparent that the economic results of exchange fund transactions were being achieved through tax-free transfers to trusts, partnerships[10] and corporate reorganization transactions,[11] Congress enacted sections 683, 721(b), and 368(a)(2)(F), incorporating the principles of section 351(e) to deny tax-free treatment for equivalent

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[5] *See, e.g.*, S. Rep. No. 1707, 89th Cong., 2d Sess. 61 (1966); H.R. Rep. No. 2327, 89th Cong., 2d Sess. 9 (1966). *See also* H.R. Rep. No. 1049, 94th Cong., 2d Sess. (1976). ("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 recognition of gain or loss if, immediately after the exchange, the transferors are in control of the corporation. Before this general rule was amended in 1966, the large unrealized gains built into the securities transferred to corporate exchange funds were claimed to be nontaxable to the investors by reason of section 351, since property (the appreciated securities) was 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 controlled the corporation immediately after the exchange.")

[6] For an in-depth discussion regarding the formation and operation of a typical "exchange fund", as such funds typically existed prior to the enactment of section 351(e), see, Marvin A. Chirelstein, *Tax Pooling and Tax Postponement – The Capital Exchange Funds*, 75 Yale L.J. 183 (1965-1966) (questioning whether the formation of an exchange fund should qualify as a tax-free exchange under section 351, as in effect prior to enactment of section 351(e)).

[7] Section 351 provides that no gain or loss is recognized on a transfer of property to a corporation solely in exchange for stock of the corporation if immediately after the exchange, the transferor or transferors "control" the transferee corporation. "Control" under section 368(c) is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of each class of outstanding non-voting stock.

[8] *See, e.g.*, S. Rep. No. 1707, 89th Cong., 2d Sess. (1966). ("In 1960 the Internal Revenue Service issued a limited number of rulings to the effect that no tax resulted from the exchange of appreciated stock for shares in an investment fund where immediately after the exchange, the persons who transferred the stock to the corporation are in control of the corporation. Investments funds organized in this way have become known as "swap funds." It stopped issuing these rulings in 1961, however, and subsequently (in Rev. Proc. 62-32) the Service announced that this was an area in which it would not rule. Notwithstanding this change in position, new swap funds continued to be formed, relying on the advice of private tax counsel that the exchange of stock for stock in these cases was nontaxable.")

[9] See Foreign Investors Tax Act of 1966, P.L. 89-809 (1966) (originally enacted as section 351(d), and later moved to section 351(e)).

[10] Section 721 generally provides that no gain or loss is recognized to a partnership or any of its partners when property is contributed in exchange for a partnership interest.

[11] Reorganization transactions described in section 368 generally result in no gain or loss recognition to the shareholders of the target corporation (section 354), the target corporation (sections 357 and 361), or the acquiring corporation (section 1032).

diversification transactions. Sections 683 and 721(b) simply cross-reference section 351(e).[12] Section 368(a)(2)(F), however, provides its own definitions and rules for determining whether a potential reorganization transaction accomplishes a prohibited diversification result.[13]

A. Section 351(e)

Section 351(e)(1) denies tax-free treatment for exchanges otherwise qualifying under section 351 where the transferee is an "investment company." The 1966 statute did not provide a definition for the term or other guidance on the scope of the provision.[14] The Treasury and Service issued regulations in 1967 (as amended, the "Regulations") that limited the scope of section 351(e) to exchanges where (i) the transfer results, directly or indirectly, in diversification of the transferor's interest[15] (the "Section 351(e) Diversification Test") and (ii) the transferee is a regulated investment company ("RIC"), a real estate investment trust ("REIT"), or a corporation more than 80 percent of the value of whose assets (other than cash and nonconvertible debt obligations) are held for investment and are readily marketable stocks or securities, or interests in RICs or REITs ("Section 351(e) 80 Percent Corporation"). (For purposes of this Report, a Section 351(e) 80 Percent Corporation, RIC, or REIT is a "Section 351(e) Investment Company").[16] In determining whether a corporation is a Section 351(e) 80 Percent Corporation, stock and securities in a subsidiary are disregarded and the parent is deemed to own its ratable share of the subsidiary's assets if the parent directly owns 50 percent or more of the subsidiary's total stock voting power or stock value (the "Section 351(e) Look-Through Rule").[17]

Under the Section 351(e) Diversification Test in the Regulations, diversification ordinarily results if two or more persons transfer non-identical assets to a corporation. Conversely, if there is only one transferor or multiple transferors of identical assets to a newly organized corporation, the transfer generally is not treated as resulting in diversification.[18] In evaluating whether a transaction meets the Section 351(e) Diversification Test, assets constituting an insignificant portion of the total value of the assets transferred are disregarded

[12] Similarly, section 683 was added to the Code in 1976 to provide that gain is recognized if property is transferred to a trust (other than a pooled income fund within the meaning of section 642(c)(5)) in exchange for an interest in other trust property and the trust would be an investment company (within the meaning of section 351) if it were a corporation.
[13] Section 584(h) was introduced in 1996 and permits the tax free transfer by a "common trust fund" of substantially all of its assets to a regulated investment company but only if the common trust fund is diversified within the meaning of section 368(a)(2)(F)(ii) prior to such transfer. *See*, Staff of the Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 104th Congress," (JCS-12-96), 194-195 (Dec. 18, 1996).
[14] *See, e.g.,* S. Rep. No. 1707, 89th Cong., 2d Sess. 61 (1966); H.R. Rep. No. 2327, 89th Cong., 2d Sess. 9 (1966).
[15] Treas. Reg. § 1.351-1(c)(1)(i).
[16] Treas. Reg. § 1.351-1(c)(1)(ii).
[17] Treas. Reg. § 1.351-1(c)(4).
[18] Treas. Reg. § 1.351-1(c)(5). In 1980, the Treasury and Service issued proposed regulations addressing transfers to pre-existing corporations, providing that such transfers would be treated as resulting in diversification unless the transferee corporation's pre-transfer assets were identical to the assets transferred. No de minimis rule was provided. The proposed regulations were withdrawn in 1998. Prop. Regs. § 1.351-1(c)(5) and -1(c)(6), withdrawn by 63 Fed. Reg. 71047 (Dec. 23, 1998).

(the "De Minimis Test") and transfers that are part of a plan to achieve diversification are integrated even if separated in time.[19]

The Section 351(e) Diversification Test in the Regulations was amended in 1996 to provide that a transfer of stocks and securities is not treated as resulting in diversification if each transferor transfers an already diversified portfolio of stocks and securities.[20] For this purpose, a portfolio of stocks and securities is diversified if it satisfies the 25-percent and 50-percent tests of section 368(a)(2)(F)(ii) (the "Section 368(a)(2)(F) 25/50 Test").[21] A corporation is diversified under the Section 368(a)(2)(F) 25/50 Test if (i) not more than 25-percent of the value of its total assets are invested in the stock and securities of any one issuer and, (ii) not more than 50-percent of the value of its total assets are invested in the stock and securities of five or fewer issuers. All members of a section 1563(a) controlled group are treated as a single issuer in determining the number of issuers, and cash and Government securities are excluded from total assets. The 1996 amendments to the Regulations liberalized the Section 351(e) Diversification Test by deviating from the Section 368(a)(2)(F) 25/50 Test and allowing the inclusion of Government securities for purposes of testing diversification under section 351(e) in the denominator of the calculation and not the numerator, unless the Government securities are acquired to meet the Section 368(a)(2)(F) 25/50 Test.[22]

In 1997, Congress modified section 351(e) by significantly expanding the list of assets held by a corporation that can cause it to be a Section 351(e) Investment Company.[23] The amendments provide that stock and securities held by a corporation are taken into account regardless of whether they are "readily marketable" and the following additional assets are treated as stocks and securities for purposes of section 351(e) ("Listed Investment Assets"):[24]

(i) money;

(ii) stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives;

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[19] Treas. Reg. § 1.351-1(c)(5).

[20] T.D. 8663, 1996-1 C.B. 34. See Treas. Reg. § 1.351-1(c)(6)(i).

[21] The preamble to the proposed version of the regulatory amendment confirms for this purpose that the "relevant provisions of Section 368(a)(2)(F) will apply to the Section 368(a)(2)(F)(ii) test [under Section 351(e)]. Those provisions include the common ownership rule found in [Section 368(a)(2)(F)(v)] (diversification will not be considered to occur if the interests in the assets to be transferred are held substantially by the same persons in the same proportions as the interests in the transferee)." CO-19-95, 1995-2 C.B. 464. The purpose of the amendments to the section 351(e) Regulations was, in part, to "minimize the different tax treatment of a Section 351 transfer and a Section 368 reorganization under economically similar situations."

[22] Inclusion of Government securities in the denominator (but exclusion from the numerator) makes it easier for a corporation (or a transferor transferring assets) to be treated as diversified. For example, assume 95 percent of a corporation's total assets are Government securities and 5 percent are invested in the stock of X Corporation. If the Government securities were excluded from the equation, 100 percent of the corporation's assets would be treated as invested in X Corporation. If the Government securities are included only in the denominator, only 5 percent of the corporation's assets are treated as invested in the stock of a single issuer.

[23] *See* P.L. 105-34, §1002(a) (1997).

[24] Section 351(e)(1)(B).

(iii) any foreign currency;

(iv) 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 which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in clauses (i) through (v) and (viii);

(v) except to the extent provided in regulations prescribed by the Secretary, any interest in a precious metal, unless such metal is used or held in the active conduct of a trade or business after the contribution;

(vi) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of any assets described in any preceding clause or clause (viii);

(vii) to the extent provided in regulations prescribed by the Secretary, any interest in any entity not described in clause (vi), but only to the extent of the value of such interest that is attributable to assets listed in clauses (i) through (v) or clause (viii); or

(viii) any asset specified in regulations prescribed by the Secretary.[25]

The 1997 legislative history confirms that, while Congress intended to expand the Listed Investment Assets, all other aspects of the Regulations remain in force, including the requirement that a contribution must result in diversification.[26] Accordingly, an exchange is now treated as a transfer to an investment company if (i) the transfer results directly or indirectly in the diversification of the transferor's interests, and (ii) the transferee is a RIC, a REIT or a Section 351(e) 80 Percent Corporation (*i.e.*, a corporation that owns at least 80 percent Listed Investment Assets).

The Treasury has not exercised its authority under section 351(e)(1)(B)(viii) to expand the list of Listed Investment Assets.

B. Section 721(b)

Section 721(b) provides that the nonrecognition treatment of section 721(a) will not apply to "gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated." Notably, unlike section 351(e), loss realized on a contribution to a partnership that is subject to section 721(b) may not be recognized.

[25] The statutory amendment contains regulatory authority to treat any asset listed in clauses (i) through (v) as not so listed. This authority has not been exercised.

[26] H.R. Rep. No. 148, 105th Cong., 1st Sess. (1997); S. Rep. No. 33, 105th Cong., 1st Sess. (1997).

C. Section 368(a)(2)(F)

Under section 368(a)(2)(F)(i), if two or more parties to a reorganization are investment companies, the transaction is not a reorganization with respect to any such investment company (and its shareholders or security holders) unless it is a RIC, REIT, or a corporation meeting the diversification standard of the Section 368(a)(2)(F) 25/50 Test described above. An investment company is a RIC, a REIT or a corporation more than 50 percent of whose total assets (excluding cash, cash equivalents, and Government securities) consist of stock or securities and 80 percent or more of the value of whose total assets are held for investment (the "Section 368(a)(2)(F) 50/80 Test" and, together with RICs and REITs, a "Section 368(a)(2)(F) Investment Company").[27] For purposes of computing whether a corporation is a Section 368(a)(2)(F) Investment Company, the stock of a subsidiary is disregarded and the parent is deemed to own its ratable share of the subsidiary's assets, with a corporation treated as a subsidiary if the parent owns 50 percent or more of the combined voting power or value of the corporation's outstanding stock (the "Section 368(a)(2)(F) Look-Through Rule").[28]

As noted above, a corporation is diversified if it meets the Section 368(a)(2)(F) 25/50 Test.[29] Under regulations to be prescribed by the Secretary, assets acquired in order to qualify for the Section 368(a)(2)(F) 25/50 Test or to cease to be an investment company will be disregarded for diversification testing purposes.[30] Section 368(a)(2)(F)(ii) describes a limited look-through rule for purposes of determining whether an investment company is diversified.[31]

Section 368(a)(2)(F) will not apply to corporations that otherwise qualify as Section 368(a)(2)(F) Investment Companies if the stock of each is owned substantially by the same persons in the same proportions (the "Common Control Exception").[32] In explaining the purpose of the Common Control Exception, the legislative history states, "[t]he amendment makes an express exception to the denial of tax-free reorganization treatment where two or more investment companies are owned substantially by the same persons in the same proportions. In these cases the shareholders and security holders of the companies being combined ordinarily will not diversify their stock investments after the transaction; the bill accordingly permits reorganizations of commonly controlled investment companies to continue to be tax-free."[33] The legislative history also indicates that Congress expected the Treasury to issue regulations

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[27] Sections 368(a)(2)(F)(iii) and (iv). Legislative history suggests that the term "securities" should be interpreted broadly for these purposes, and is intended to include obligations of state and local governments (including industrial development bonds), stock warrants, stock options and rights, commodity futures, mutual fund shares, interest in REITs, commercial paper, corporate notes, participating interests in federally guaranteed or insured mortgage or other loan pools, and interests in partnerships the sale of which are required to be registered with the SEC or comparable state agencies. H.R. Rep. No. 1049, 94th Cong., 2d Sess. (1976).

[28] *Id.*

[29] Sections 368(a)(2)(F)(ii) and (iv). For these purposes, all members of the same controlled group of corporations (within the meaning of section 1563(a)) are treated as one issuer.

[30] Section 368(a)(2)(F)(iv).

[31] Section 368(a)(2)(F)(ii).

[32] Section 368(a)(2)(F)(v).

[33] S. Rep. No. 938, Part 2, 94th Cong., 2d Sess. (1976); *General Explanation of the Tax Reform Act of 1976*, H.R. 10612, 94th Congress, Public Law 94-455, 94th Cong., 2d Sess. 665 (1976).

establishing the "detailed rules needed to carry out the purposes of this exception" and to adopt a rule providing that the exception would not apply if common control over two or more corporations is obtained in order to bring a reorganization within the scope of the Common Control Exception.[34] While diversification is not a per-se requirement under section 368(a)(2)(F), as it is under the section 351(e) Regulations, it is clear the intent was to prevent tax-free mergers that result in diversification.

Regulations were proposed under section 368(a)(2)(F) in 1981, but were withdrawn in 1998 (together with the withdrawn regulations under Section 351(e), the "Withdrawn Proposed Regulations").[35] The Withdrawn Proposed Regulations provided guidance on a number of issues relating to the application of section 368(a)(2)(F), including:

- *Definition of the term "securities"*. The Withdrawn Proposed Regulations defined the term "securities" to include state and local government obligations, commodity futures contracts, shares of RICs and REITs, and items treated as securities under the Investment Company Act of 1940 (the "1940 Act").[36] Consistent with the treatment of partnership interests under the 1940 Act, partnership interests held by passive general partners or limited partners were generally treated as securities. However, treasury stock was not treated as a security under the Withdrawn Proposed Regulations despite its treatment under the 1940 Act.[37]

- *When assets are "held for investment"*. The Withdrawn Proposed Regulations treated assets as held for investment if such assets were (1) held primarily for gain from appreciation in value, production of passive income or both, and (2) not held primarily for sale to customers in the ordinary course of a trade or business.[38] "Passive income" included royalties, rents, dividends, interest and annuities.[39]

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[34] S. Rep. No. 938, Part 2, 94th Cong., 2d Sess. 4077 & fn. 702 (1976). The Senate Report cited then-effective Treas. Reg. § 1.382(b)-1(d)(3) as an example of a similar anti-abuse provision.

[35] *See* Prop. Regs. § 1.368-4 (1981); LR-135-76, 1981-1 C.B. 735, *withdrawn by* REG-116099-98, 1999-1 C.B. 822.

[36] As described in the Withdrawn Proposed Regulations, this includes "any note, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral right, or in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing."

[37] Prop. Regs. § 1.368-4(c)(5).

[38] Prop. Regs. § 1.368-4(d)(1).

[39] Prop. Regs. § 1.368-4(d)(2). Note that an example in the Withdrawn Proposed Regulations also suggested a rule for determining whether a dealer held an asset for investment. The example indicated that an asset would generally be considered held for investment when a taxpayer would be permitted to claim capital gain treatment under section 1236 with respect to the sale of an asset. Section 1236 permits dealers to treat certain stock as held for investment, making such stock eligible for capital gain treatment. *See* Prop. Regs. § 1.368-4(d)(5) Example 2. The Withdrawn Proposed Regulations also provided that when a taxpayer occupies a portion of real property for its business and

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- *Diversification testing look-through rule*. The Withdrawn Proposed Regulations provided that the Section 368(a)(2)(F) Look-Through Rule applied for purposes of testing whether a corporation is an investment company would also apply for testing diversification.[40] Specifically, a parent corporation would be deemed to own its ratable share of the assets of 50 percent-owned corporate subsidiaries for purposes of determining whether the parent corporation was diversified.[41]

- *Anti-abuse rule*. The Withdrawn Proposed Regulations provided that assets are excluded from the investment company and diversification determinations if they were acquired for the purpose of terminating a corporation's status as a Section 368(a)(2)(F) Investment Company or qualifying a Section 368(a)(2)(F) Investment Company as diversified.[42] The Withdrawn Proposed Regulations required the purpose to be a "major" purpose of the acquisition, and established a presumption that assets were acquired for an impermissible purpose if they were acquired by a corporation that was a Section 368(a)(2)(F) Investment Company at any time during the 365 days immediately prior to the acquisition.[43] This presumption generally did not apply during the first year after the formation of a new corporation.[44] The Withdrawn Proposed Regulations also provided that corporations that become undiversified as a result of asset sales could in certain instances purchase new assets within 30 days to become diversified again without those assets being excluded under the anti-abuse rule.[45] This "30 day grace period" was available to corporations once every two taxable years.[46]

- *Common Control Exception*. The Withdrawn Proposed Regulations included examples illustrating when two investment companies would be considered to be "owned substantially by the same persons in the same proportions."[47]

- *Triangular transactions*. The Withdrawn Proposed Regulations included special rules for triangular transactions.[48] Under those rules, in determining whether two or more investment companies were parties to a

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rents out the remaining portion, each portion should be treated as a separate asset in determining investment company status.

[40] As discussed in Part IV.B.2 below, the diversification look-through rule in the Withdrawn Proposed Regulations is consistent with the legislative history of the Tax Reform Act of 1976.

[41] Prop. Regs. § 1.368-4(g).

[42] Prop. Regs. § 1.368-4(j)(1).

[43] Prop. Regs. § 1.368-4(j)(3).

[44] Prop. Regs. § 1.368-4(j)(4).

[45] Prop. Regs. § 1.368-4(j)(5).

[46] *Id.*

[47] Prop. Regs. § 1.368-4(k). For a discussion of the examples, *see* Part IV.B.3.

[48] Prop. Regs. § 1.368-4(o).

transaction, the acquirer and its acquisition subsidiary were treated as a single party, and the target was a single party. As a result, if the target was not a Section 368(a)(2)(F) Investment Company, section 368(a)(2)(F) would not apply to the transaction, even though both the acquirer and its acquisition subsidiary were Section 368(a)(2)(F) Investment Companies.[49]

IV. Discussion of Recommendations

A. Section 351(e)

1. Section 351(e) Investment Company

a. Listed Investment Assets

Sections 351(e) and 368(a)(2)(F) were enacted to prevent the same perceived abuse yet each defines an "investment company" differently. In determining whether a corporation is a Section 368(a)(2)(F) Investment Company, all assets held by it for "investment" are taken into account, while for purposes of determining whether a corporation is a Section 351(e) 80 Percent Corporation, only the specifically enumerated Listed Investment Assets are relevant. Congress significantly expanded the Listed Investment Assets in 1997 in direct response to transactions that it viewed as economically equivalent to those transactions section 351(e) was originally intended to prevent.

While the expanded Listed Investment Assets prevented certain abuses, taxpayers have adapted and similar structures continue, relying on the rule that excludes a corporation from section 351(e), and thus from section 721(b), if 20 percent or more of its assets are not Listed Investment Assets.[50] While several legislative proposals have been advanced that would again expand the Listed Investment Assets to combat specific abuses,[51] the authority in section 351(e)(1)(B)(viii) authorizing the Treasury to issue regulations that expand the Listed Investment Assets is sufficiently broad to allow the Treasury to address these transactions by regulations.

Because Listed Investment Assets is an incomplete list of assets that are held for investment and that should be taken into account for purposes of the investment company provisions, a majority of the Tax Section recommends that the Treasury and Service adopt the section 368(a)(2)(F) concept of "investment assets" and treat any asset held for investment as a

[49] *Id.*

[50] *See*, Herzig, *supra* note 3.

[51] H.R. 2705, 106th Cong. (1999), H.R. 1785, 107th Cong. (2001), and H.R. 2406, 107th Cong. (2001). Commenting on the 1999 legislation, Congressman Richard E. Neal stated in a press release, "Like the Legendary phoenix, a bird that lived for 500 years, burned itself to ashes on a pyre, and rose alive from the ashes to live again; this swap fund transaction has been closed down by Congress three times to date only to see life again in the form of new and more exotic designs to get around whatever restrictions had been placed into the law." The press release further noted that taxpayers were avoiding section 351(e) by "holding at least 21 percent assets in preferred and limited interests in limited partnerships holding real estate," and proposed the addition of "any interest in any entity if the return on such interest is limited and preferred" to the Listed Investment Assets (1999 TNT 150-19 – Congressional News Release).

Listed Investment Asset. If this recommendation is adopted, the application of the investment company provisions would not be dependent on an incomplete list of investment assets and would be less arbitrary. As part of this proposal, we recommend a definition of "assets held for investment" be included in the Regulations. The Withdrawn Proposed Regulations included a definition that provided a useful standard for taxpayers.[52] The Treasury and Service may improve upon that definition by focusing on whether the assets are held for the production of passive income, rather than held for gain from appreciation in value.

A substantial minority of the Tax Section believes an expansion of the Listed Investment Assets is more properly within the purview of Congress, as evidenced by the introduction of proposed tax legislation that would add items to the list.

b. Treatment of Cash as a Listed Investment Asset

Among the complications raised by the 1997 expansion of Listed Investment Assets are issues arising from inclusion of "money" on that list. Particularly in "start up" situations, cash contributed to a newly formed corporation to fund capital investment and working capital needs could, at least for a period of time following formation, constitute more than 80 percent of the value of the enterprise. In such a case, the cash could result in taxation of other transferors of bona fide business assets (such as intellectual property or contractual rights) to the corporation, a result that is seemingly inconsistent with the overall purpose of section 351 of permitting tax-free incorporation of ongoing or new businesses and quite far afield from the potential abuses that section 351(e) was enacted to prevent. The treatment of cash as a Listed Investment Asset, without further modification, may also be a trap for the unwary. We note that, even if our proposal in the prior section to replace the list of investment assets with an "assets held for investment" standard is adopted, the treatment of cash as an investment asset would still need clarification and further guidance.

The potential escape hatch from taxation under section 351(e) for cash-intensive start-ups and other analogous fact patterns lies in the concept that, under Treas. Reg. § 1.351-1(c)(2), a planned use of transferred cash to acquire non-investment assets may be taken into account. Specifically, the Regulations provide that:

> The determination of whether a corporation is an investment company shall ordinarily be made by reference to the circumstances in existence immediately after the transfer in question. However, where circumstances change thereafter

[52] *Assets held for investment* – (1) General rule. Assets are held for investment…, if,

> (i) They are held primarily for (A) gain from appreciation in value, (B) production of passive income, or (C) both of these, and
>
> (ii) They are not held primarily for sale to customers in the ordinary course of a trade or business (within the meaning of section 1221(1)).

Prop. Regs. § 1.368-4(g).

> pursuant to a plan in existence at the time of the transfer, the determination shall be made by reference to the latter circumstances.[53]

Indeed, in enacting the 1997 amendments, Congress recognized the importance of this provision to cash contributions. The 1997 Blue Book notes that:

> [A]lthough under the Act, money is counted toward the 80percent test, where money is contributed to a corporation or partnership and, pursuant to a plan, either (1) assets not counted toward the 80percent test are purchased or contributed to the entity or (2) the entity makes expenditures not resulting in the acquisition of an asset (e.g., salaries), the investment company determination would be made on the basis of the entity's assets after such events.[54]

In light of this guidance, the well-advised will presumably carefully document the intended use of the cash in any situation in which cash transfers, taken together with other investment assets, may result in a corporation falling into Section 351(e) Investment Company status. Of course, what constitutes a plan is a notoriously ambiguous concept, in this context as elsewhere.[55] As a result, taxpayers may justifiably be concerned that section 351(e) could potentially be asserted in cases in which, for example, cash will be invested for a period of time following the transfer pending its eventual deployment in an operating business.

Accordingly, we recommend that the Treasury and Service provide guidance to give taxpayers additional certainty in cases that are least likely to implicate the policy underpinnings of section 351(e). Specifically, we propose that when there are transfers of cash and substantially all of the other property transferred consists of property that is not Listed Investment Assets, there should be a presumption that the cash will not be treated as a Listed Investment Asset for purposes of the Section 351(e) 80 Percent Corporation test. The presumption would be rebuttable if it were established that there was in fact at the time of the transfer a plan for the cash to be invested on a permanent basis in other Listed Investment Assets.

Indeed, it can fairly be argued that, from a policy perspective, cases in which substantially all of the assets transferred consist of non-Listed Investment Assets and cash should lie altogether beyond the scope of, and thereby be exempted entirely from, the coverage of section 351(e). The Treasury and Service may wish to consider such an approach.[56]

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[53] Treas. Reg. § 1.351-1(c)(2).

[54] Staff of the Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997" (JCS-23-97), 182-85 (Dec. 17, 1997).

[55] *See* Monte A. Jackel and James B. Sowell, *Transfers to Investment Companies: Complexity in a Conundrum*, Tax Notes 1666-67 (March 25, 2002), reprinted in Practising Law Institute 2010, vol. 14, at 200-12 (discussing various issues with respect to the application of this plan requirement).

[56] A further question raised by the emphasis on the planned use of cash in cases in which cash and other Listed Investment Assets are transferred is how to analyze a fact pattern if there is no fixed plan regarding the eventual use of cash. Consider, for example, a case in which one transferor contributes $50 of X stock to a newly formed corporation and the other transferor contributes $50 of cash. At the time of the transfer, there is no particular plan as to how the cash will be used. It might be argued that in the absence of an affirmative purpose of investing the cash

(footnote continued)

c. Application of Section 351(e) Look-Through Rule

Because "stock" is a Listed Investment Asset, in the absence of a look-through rule, stock of a subsidiary counts towards the determination of whether the holder of such stock is a Section 351(e) 80 Percent Corporation. The Section 351(e) Look-Through Rule allows a direct 50 percent shareholder to ignore its stock ownership and be treated as directly holding a proportionate share of the subsidiary's assets.[57] This Report makes two recommendations to expand the Section 351(e) Look-Through Rule.

First, there are no attribution rules in section 351(e) and, therefore, if a subsidiary is owned by multiple members of a related group (none of which owns 50 percent by itself), the Section 351(e) Look-Through Rule does not seem to apply.

> *Example 1.* Corporation X owns all the stock of Y, a holding company. Y's only asset is 30 percent of the stock of Z, an operating company that holds no assets unrelated to its business operations. The remaining 70 percent of the stock of Z is owned by W, another wholly owned subsidiary of X. X transfers appreciated assets to Y in exchange for additional Y stock. Under the Section 351(e) Look-Through Rule, Z's operating business assets are not attributed to Y because it owns less than 50 percent of the Y stock directly and, therefore, Y is a Section 351(e) 80 Percent Corporation.

The transfer of property to Y does not result in diversification by X or any member of the X group. We recommend that the Treasury and Service provide for the aggregation of ownership of related entities for purposes of the Section 351(e) Look-Through Rule by applying the attribution rules of section 318 to determine whether the 50 percent threshold for look-through treatment is met. If the threshold is met, we recommend that a shareholder be treated as owning a pro rata share of the subsidiary's assets (such that Y, in the example above, would be treated as owning an undivided 30 percent interest in each of Z's assets).

Second, in determining whether or not a corporation is treated as a Section 351(e) 80 Percent Corporation, there is no statutory rule allowing taxpayers to "look through" entities other than corporations. Listed Investment Assets include interests in non-corporate entities

(footnote continued)

in other Listed Investment Assets, the newly formed corporation should not be treated as a Section 351(e) 80 Percent Corporation. On balance, however, we believe that, in light of the express inclusion of money in the statutory list of Listed Investment Assets, cash should be treated as a Listed Investment Asset absent an affirmative plan to use the cash for other purposes, and accordingly that the newly formed corporation should be treated as a Section 351(e) 80 Percent Corporation on these facts.

[57] While the statutory language of section 368(a)(2)(F) provides the 50 percent standard, there is no similar constraint in section 351(e). It may not be desirable to create further distinctions between the operating rules of section 351(e) and 368(a)(2)(F), however we note there is no impediment to providing a lower threshold for the Section 351(e) Look-Through Rule and other areas of law view 20 percent ownership as sufficient to treat the interest as other than passive. *See, e.g.*, section 243 (providing for a dividends received deduction where a shareholder owns at least 20 percent of a corporation).

substantially all of the assets of which are Listed Investment Assets, except as provided in regulations. In addition, to the extent provided in regulations, interests in other entities may also be treated as Listed Investment Assets. The legislative history of the Revenue Reconciliation Act of 1997 indicates that, until regulations are issued, Congress intended that the regulations promulgated under section 731(c)(2) generally will apply.[58] Applying the standard of those regulations, "substantially all" of the assets of an entity are Listed Investment Assets if 90 percent or more of its assets consist "directly or indirectly" of Listed Investment Assets.[59] When 20 percent or more but less than 90 percent of an entity's assets consist of Listed Investment Assets, a corresponding portion of a taxpayer's interest in the entity will be treated as a Listed Investment Asset.[60] Presumably, when less than 20 percent of a non-corporate entity's assets are Listed Investment Assets, interests in such entity are not Listed Investment Assets.

Notwithstanding the section 731(c)(2) approach reflected in the legislative history, we believe that the Treasury and Service should consider adopting a pure look-through approach, under which a portion of any interest in a partnership or other non-corporate entity would be treated as a Listed Investment Asset based on the percentage of Listed Investment Assets held by that partnership or entity. A pure look-through rule would be consistent with the aggregate theory of partnerships and with guidance in other areas that takes an aggregate approach to the determination of assets held through partnerships.[61] A pure look-through approach also represents the most precise measure of the extent of a corporation's exposure to Listed Investment Assets, and it may also help to avoid the possibility of unwarranted "cliff effects" or "gaming" due to the somewhat arbitrary 90 and 20 percent cutoffs in the section 731(c)(2) approach (a point discussed further below).

That said, we understand that a pure look-through rule could increase compliance burdens – for example, by requiring a corporation to determine the exact extent of Listed Investment Assets held by operating partnerships that by their nature would have less than 20 percent of their value invested in such assets. Accordingly, we believe adoption of rules similar to the regulations under section 731(c)(2) would also be acceptable if the Treasury and Service were to conclude that the pure look-through approach were in fact materially more burdensome from a compliance standpoint.[62] Any such rules should clarify that an interest in a partnership or entity will not be treated as a Listed Investment Asset when fewer than 20 percent of the assets of such partnership or entity are Listed Investment Assets.

[58] S. Rep. No. 33, 105th Cong., 1st Sess. (1997), p. 131.
[59] Treas. Reg. § 1.731-2(c)(3)(i).
[60] Treas. Reg. § 1.731-2(c)(3)(ii).
[61] *See* Treas. Reg. § 1.856-3(g) (for diversification testing purposes, treating a REIT as owning its proportionate share of the assets of a partnership in which the REIT is a partner); Rev. Proc. 2001-57, 2001-50 I.R.B. 577 (providing that a RIC organized as a feeder fund in a "master-feeder" structure would be deemed to own a proportionate share of the assets of the master partnership for, *inter alia*, purposes of determining whether the RIC met the diversification requirement of section 851(b)(3), subject to certain conditions).
[62] We note that, if a section 731(c)(2) approach were adopted for non-corporate entities, interests in entities that are disregarded from their owner under Treas. Reg. § 301.7701-2 would not be subject to that rule. Rather, consistent with their disregarded status, the assets of a disregarded entity should be treated as owned directly by the entity's sole owner.

Moreover, in issuing guidance to implement the section 731(c)(2) approach, the Treasury and Service should clarify the calculation of Listed Investment Assets held through tiered partnerships. The regulations are not clear as to what an "indirect" interest in a Listed Investment Asset is in the context of a tiered partnership, as shown by the following example.

> *Example 2*. Parent owns 100 percent of stock of two corporate subsidiaries, A and B, and no other assets. A and B each own 50 percent of the interests of P1 and P2, partnerships, and no other assets. P1 and P2 each own 50 percent of the interests of PS1 and PS2, also partnerships. PS1 and PS2 each hold $19 in Listed Investment Assets and $81 in other assets. P1 and P2 each hold $38 in Listed Investment Assets, their interests in PS1 and PS2, and $62 in other assets. 28.5 percent of the assets owned indirectly by Parent are Listed Investment Assets.[63] However, if the interests in PS1 and PS2 are treated as assets other than Listed Investment Assets, Parent would not be treated as holding any Listed Investment Assets.

2. Section 351(e) Diversification Test

a. Effect of Diversification on Other Transferors

Section 351(e) provides simply that "[t]his section [351] shall not apply to [a] transfer of property to an investment company." Section 351(a) provides that "[n]o 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 (as defined in section 368(c)) of the corporation." Thus, it is clear that if one person transfers property to a Section 351(e) Investment Company and achieves diversification, section 351(a) will not apply. If more than one transferor transfers property to a Section 351(e) Investment Company in the transaction, however, it is not clear whether section 351(a) will continue to provide tax-free treatment to the other transferors if one transferor achieves diversification.

> Example 3. Willard transfers a diversified portfolio to newly-formed X Corporation in exchange for 80 percent of the X Corporation stock and Dale transfers ABC stock to X Corporation in exchange for 20 percent of the X Corporation stock. Section 351(e) denies tax-free treatment to Dale because he has diversified his interest in ABC stock, but what about Willard?

> Example 4. Same as Example 3, except Willard receives 70 percent of the X Corporation stock and Dale receives 30 percent.

There are three possible interpretations of the statutory language. First, section 351(e) could be interpreted as providing that any and all transfers to a Section 351(e) Investment

[63] PS1 (19/100) + PS2 (19/100) + P1's non-PS1, non-PS2 assets (38/100) + P2's non-PS1, non-PS2 assets (38/100) = 114/400 = 28.5%.

Company will be denied tax-free treatment under section 351(a) if there is a transferor that achieves diversification in the transaction, thereby subjecting both Willard and Dale to tax on their exchanges. Second, section 351(e) could be interpreted as providing that the transferor who achieves diversification should be taxed (Dale), but one or more other transferors (Willard) may still qualify under section 351(a) if those transferors satisfy the requirements of section 351(a) on their own. Third, section 351(e) could be interpreted as providing that, while the transferor who achieves diversification is taxed (Dale), that transferor continues to be treated as a transferor for purposes of determining whether the other transferors (Willard) satisfy the control requirement.

Section 351(e), as drafted by Congress, did not contemplate a situation in which different transferors may receive different treatment. The Treasury and Service added the requirement that the transferor achieve diversification in order for section 351(e) to apply, creating the possibility that in the same transaction, some transferors may not be within the scope of section 351(e) while others are. We note that Congress affirmed the diversification requirement when it modified section 351(e) in 1997, suggesting it recognized the possibility of disparate treatment for different transferors.[64]

Where the non-diversifying transferors independently satisfy the requirements of section 351(a), we believe they should be afforded the tax-free treatment of that section. We do not believe the ambiguity in the statute compels a determination that the otherwise qualifying transfers should be taxable solely because they are part of the same transaction that involves a transfer that achieves diversification. Thus, we believe that Willard should continue to be afforded tax-free treatment under section 351(a) in Example 3. While Dale has diversified, Willard contributed an already-diversified portfolio and satisfies the requirements of section 351(a) on his own.

Example 4 raises an additional interpretative question. Willard does not control X Corporation immediately after the exchange and, therefore, does not satisfy the requirements of section 351(a) by himself. The question then arises as to whether Dale should be treated as a co-transferor despite the fact that his transfer will not qualify under section 351(a). The statutory language of section 351(e) provides solely that section 351 will not apply to a transfer of property to an investment company. In contrast, section 351(g) focuses on each transferor separately and provides that section 351(a) will not apply to a transferor that transfers property in exchange for nonqualified preferred stock ("NQPS"). Under section 351(g), if a transferor receives only NQPS, the transferor is taxable under section 1001; however, the NQPS received will continue to be taken into account for purposes of satisfying the control requirement.[65] In contrast, under section 351(d), if a service provider receives stock in exchange for services, the stock received is not taken into account for purposes of satisfying the control requirement, unless the service provider also receives stock that is not in exchange for services.[66]

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[64] *See*, Part III.A, *supra*, note 30.

[65] *See*, H.R. Rep. No. 105-356, 105th Cong., 1st Sess. (1997). ("As under the 1997 Act, the nonqualified preferred stock continues to be treated as stock received by a transferor for purposes of qualification of a transaction under section 351(a), unless and until regulations may provide otherwise")

[66] *See*, Treas. Reg. § 1.351-1(a)(2), Ex. (3).

Unlike the statutory language of sections 351(d) and (g), the language in section 351(e) does not reflect the fact that different transferors may be treated differently under the Regulations. The broad language of section 351(e) may suggest that a transferor that achieves diversification should not be treated as part of the transferor group. In addition, because section 351 was enacted to allow for the incorporation of a business and Congress does not view section 351(e) transfers as consistent with that policy, a conclusion could be reached that treating a diversifying transferor as part of the control group is not entirely consistent with the policy. However, because the application of section 351(e) was narrowed by regulations requiring diversification (and such requirement was approved by Congress in the 1997 legislative history) so that each transferor is analyzed separately, such a reading of the statute does not seem appropriate or compelled. The policy of section 351(e) seems to require only that the transferor that achieves diversification is taxed, and such policy is not thwarted by recognizing that the diversifying transferor has received transferee corporation stock and allowing such stock to be counted toward the control immediately after requirement. Therefore, we recommend that Willard receive tax-free treatment for his non-diversifying transfer of property regardless of whether he controls the transferee corporation.[67]

b. Treatment of Cash

The question of how cash should be treated for purposes of the Section 351(e) Diversification Test is a point on which there is considerable, and unwarranted, uncertainty. In Rev. Rul. 87-9,[68] certain shareholders of corporation Y transferred their Y stock to X, a newly organized corporation intending to qualify as a RIC, in exchange for 89 percent of the stock of X. Other persons transferred cash to X, receiving in exchange 11 percent of X's stock. The ruling holds that the transfers constitute transfers to a Section 351(e) Investment Company and, therefore, that the transferors of the Y stock were required to recognize gain or loss on the transaction. According to the ruling, the Y stock and the cash are "non-identical assets," and the cash represented a significant part of the value of the property transferred to X (*i.e.*, so that the cash contribution could not be considered *de minimis*). Accordingly, the transfers were treated as resulting in diversification within the meaning of the Regulations. Noticeably absent from Rev. Rul. 87-9 is any discussion of the intended use of the cash. It seems reasonable to assume, though, that because the transferee corporation intended to qualify as a RIC, the cash would be used to acquire assets that would satisfy the diversification requirements under the RIC rules[69] (*i.e.*, assets other than Y stock) and, as further discussed below, this may well have been an unstated underpinning of the holding.

The treatment of cash in Rev. Rul. 87-9 raises questions in two contexts. Most importantly, there is the question of whether a transfer of cash by one or more transferors will cause otherwise qualifying transfers of diversified portfolios by other transferors to be taxable. Perhaps the paradigm case that raises this question is the incorporation of a diversified

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[67] We note the adoption of this proposal would allow Dale to contribute depreciated securities to the transferee corporation and recognize a loss, while Willard contributes appreciated securities to the transferee corporation and defers his gain.

[68] 1987-1 C.B. 133.

[69] Section 851(b)(3).

investment partnership to form a RIC, whether by means of the partnership contributing its assets to a newly formed corporation or by converting the partnership into (or making an entity classification election for the partnership to be treated for tax purposes as) a corporation, combined with a simultaneous public offering of the RIC's shares. Under a literal reading of the Regulations and Rev. Rul. 87-9, one might conclude that cash transfers by the new public investors, if sufficiently substantial and integrated with the transfer (or deemed transfer) of the partnership portfolio, would cause the partnership incorporation transaction to be taxable. In particular, the analysis might conclude that the transaction does not satisfy the exception for transfers of diversified portfolios because cash by itself does not literally satisfy the Section 368(a)(2)(F) 25/50 Test and, accordingly, it is not the case that "each transferor transfers a diversified portfolio."[70] If the Section 368(a)(2)(F) 25/50 Test exception is not available, the transaction then fails the general test in the Regulations because the cash and the diversified portfolio transferred (or deemed transferred) by the partnership are non-identical assets. This, in turn, results in the transfer of assets by the partnership to the new RIC constituting a taxable transfer to a Section 351(e) Investment Company.

Fortunately, the Service has not adopted such a wooden reading of the Regulations and held in private letter rulings ("PLRs") that transfers of cash by some transferors will not cause transfers of diversified portfolios by other transferors to be taxable.[71] Commentators have speculated that the underlying rationale for such PLRs is that the cash transferors could have used the cash to purchase diversified portfolios and transferred those to the new corporation.[72] An alternative rationale might be to regard contributions of diversified portfolios as being incapable of further diversification,[73] while treating cash as an inherently diversified asset, although such treatment of cash might well be problematic as applied to fact patterns in which cash is intended to be used to acquire identical assets to those transferred by transferors of non-cash, non-diversified assets, as discussed below. Regardless of which rationale is applied, the holdings of these PLRs are clearly the correct result as a policy matter.

We have recommended in Part IV.A.2.a of the Report generally that a transfer of non-diversified assets by one transferor should not cause the transfer of a diversified portfolio by another transferor to be taxable under section 351(e). Adoption of this recommendation would remove uncertainty regarding whether a transferor of a diversified portfolio might be rendered taxable as a result of cash contributions by other transferors. If, however, this recommendation is not adopted, the Treasury and Service should at a minimum issue published guidance endorsing the holding of the PLRs and making clear that a transfer of cash will not be treated as

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[70] Treas. Reg. § 1.351-1(c)(6)(i).

[71] *See* PLR 200931042 (holding that there was no taxable transfer to an investment company for purposes of section 721(b) when each transferor transferred solely cash and/or a diversified portfolio of securities to an LLC); PLR 9826035 (holding that contemporaneous contributions of diversified portfolios and cash would not be taxable under the investment company rules).

[72] *See* Jackel and Sowell, *Transfers to Investment Companies* at 1672.

[73] Query, however, whether that is actually the case as an economic matter. *See* Barnet Philips IV, *Exchange Funds: What is Diversification?*, Practising Law Institute 2011, vol. 14 at 199-21 to 199-22 (considering a case in which one transferor transfers a diversified portfolio of high-grade debt obligations and the other transfers a diversified portfolio of speculative high-tech stocks).

a diversifying transfer that causes otherwise qualifying transfers of diversified portfolios to be taxable.

The other context in which the treatment of cash raises questions is when, as in Rev. Rul. 87-9, one or more transferors transfer identical non-diversified investment assets while other transferors transfer cash as part of the same plan. Will such a transaction necessarily result in diversification in all cases, or does this depend on the use of the cash? Consider, for example, a case with the same facts as Rev. Rul. 87-9, except that the transferee corporation intends to and does use the cash to acquire additional Y stock.[74] As indicated above, it seems reasonable to assume that Rev. Rul. 87-9 was premised on the understanding that the RIC would use the cash to make diversifying investments. As such, the ruling should be viewed as reflecting the general principle that if there is a plan in existence at the time of the transfer, the determination of whether a corporation is an investment company is made by reference to the circumstances existing following completion of the plan. More specifically, since one presumes – there was a plan for the cash in Rev. Rul. 87-9 to be used to acquire investment assets not identical to the Y stock, diversification was present.

By contrast, if the transferred cash were used to acquire identical assets to those contributed by the other transferors, there is no diversification. Accordingly, we recommend that the Treasury and Service clarify that a transfer of cash will not be treated as a transfer of a non-identical asset, and hence will not result in taxation of other transferors, if the cash is intended to be used, and is used, to acquire assets identical to those contributed by the other transferors.[75]

c. Transferor Attribution Rule

In examining whether a transferor has diversified, the Section 351(e) Diversification Test in the Regulations only examines assets directly transferred by that transferor. There is no attribution rule in the Regulations that would treat one transferor as owning another transferor's assets. As a result, section 351(e) could apply where the transferred assets are indirectly owned by the same person, or by multiple transferors that ought otherwise to be treated as a single person, even though there has been no economic diversification.

[74] *See id.*

[75] *See* Phillips, *Exchange Funds*, at 199-15. One may well note the limitations of the focus on whether identical assets are transferred (or, as discussed in the text, acquired with transferred cash) in preventing tax-free diversification to the extent that there may be transactions that comply with this requirement while still permitting diversification. Thus, for example, in PLR 9607005, the Service held that, after contributions of identical investment assets, a partnership could borrow against those assets and use the proceeds to acquire non-identical stocks and securities without running afoul of section 721(b). The PLR is apparently based on the premise that diversification was not achieved by means of the transfer, but rather by the subsequent borrowing and securities purchases undertaken by the newly formed partnership, *cf.* Rev. Rul. 88-32, and possibly also on the understanding that each of the transferors could have leveraged its own investment assets to diversify outside of the partnership. We agree with the holding of PLR 9607005 as an interpretive matter, although it does demonstrate that section 351(e) and section 721(b) do not foreclose all approaches to achieving a measure of tax-free diversification of investment assets.

> *Example 5*. Parent owns Sub 1 and Sub 2. Sub 1 transfers X stock, and Sub 2 transfers Y stock, to a newly formed corporation. If Sub 1 and Sub 2 are treated as two separate transferors, each has diversified.

Note that if Sub 1 had merged into Sub 2, the Common Control Exception would have protected the transaction from tax under section 368(a)(2)(F). We do not think that the result should be different under section 351(e). Parent owns the same assets (indirectly) after the transaction as it did before the transaction. Accordingly, it has not achieved economic diversification.

Failing to provide an attribution rule in this context limits the ability of a related group of companies to transfer assets within the group in a tax-efficient manner. Intragroup transfers are not the types of abuses targeted by section 351(e).

> Example 6. Husband, Bill, transfers X stock, and wife, Karen, transfers Y stock, to a newly formed corporation. If Bill and Karen are treated as two separate transferors, each has diversified.

In this case, again, the taxpayers have not achieved economic diversification, because for a number of tax law purposes, spouses are treated as essentially one taxpayer. This instance is even more stark than Example 5 because not only has no diversification been achieved, but Husband and Wife could also have, under section 1041, exchanged their stock with each other outside of section 351 without recognizing gain. Accordingly, there is neither economic diversification nor an avoidance of tax that would be otherwise recognized.

We recommend that the Treasury and Service adopt an attribution rule for purposes of the Section 351(e) Diversification Test that would (i) treat all the members of a "qualified group" (as defined in Treas. Reg. § 1.368-1(d)(4)(ii), except that the qualified group would be tested starting with the common parent and would include any partnership that would have been treated as a member of the qualified group if it had been a corporation) as a single person that owns all of the assets held by such qualified group and transfers all of the assets transferred by all qualified group members and (ii) treat all the members of a family (as described in section 318(a)(1)) as a single person that owns all of the assets held by each member of the family and transfers all of the assets transferred by all family members. As a result, in each of Examples 5 and 6 above, there would be a single transferor (the Parent qualified group or the Husband/Wife family) that is treated as transferring all of the X and Y stock to the newly formed corporation for purposes of the Section 351(e) Diversification Test. Such a rule would avoid taxing transactions that do not result in economic diversification. This recommendation and our recommendation regarding the Common Control Exception (see Part IV.B.3. below) would also help achieve greater conformity between section 351(e) and section 368(a)(2)(F). Finally, these rules would better allow a related group of companies to transfer assets within the group, which is not an abusive use of section 351.

d. Government Securities Acquired to Meet Section 368(a)(2)(F) 25/50 Test

In general, a transferor is treated as having transferred a diversified portfolio of stocks or securities if the portfolio satisfies the Section 368(a)(2)(F) 25/50 Test. As described above, however, the Regulations adopt a different approach to Government securities than is applied under section 368(a)(2)(F). Specifically, for purposes of determining total assets in applying the Section 368(a)(2)(F) 25/50 Test, section 368(a)(2)(F)(iv) provides that there shall be excluded "cash and cash items (including receivables), Government securities, and, under regulations prescribed by the Secretary, assets acquired (through indebtedness or otherwise) for purposes of meeting" the diversification requirements or ceasing to be an investment company. Thus, under section 368(a)(2)(F), Government securities generally are not taken into account in evaluating compliance with the Section 368(a)(2)(F) 25/50 Test.[76]

By contrast, the Regulations adopt a more taxpayer favorable approach to Government securities. They provide that "Government securities are included in total assets for purposes of the denominator of the 25- and 50-percent tests (unless Government securities are 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."[77] Under this rule, Government securities included as part of a transfer will generally facilitate meeting the Section 368(a)(2)(F) 25/50 Test because they increase the denominator without increasing the numerator.

The rationale underlying the distinct treatment of Government securities under section 351(e) was explained in the preamble to the Regulations permitting transfers of diversified portfolios when they were initially proposed in 1995. According to the preamble:

> The proposed modification of the definition of total assets to include Government securities addresses a problem caused by transfers of funds consisting mostly of Government securities. For example, if 95 percent of a money market fund's assets are invested in Government securities and five percent are invested in the stock of corporation X, the Government securities would not be treated as securities (see section 368(a)(2)(F)(vii)) and, without the modification, would be excluded from total assets for purposes of the 25- and 50-percent test of section 368(a)(2)(F)(ii). As a result, the unmodified test would treat 100 percent of the fund's assets as X stock and the fund would not satisfy the 25- and 50-percent test of section 368(a)(2)(F)(ii). The modified test would include Government securities in total assets. The fund would satisfy the modified test because the stock of one issuer would constitute only five percent of the fund's portfolio. The IRS believes that the modification is appropriate because the presence of a small amount of nondiversified property in a Government securities portfolio (otherwise

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[76] Although the statute technically excludes Government securities only from the denominator of the 25 and 50-percent measures, it is reasonable to assume that exclusion from the denominator implies exclusion from the numerator as well.

[77] Treas. Reg. § 1.351-1(c)(6).

> qualifying under section 368(a)(2)(F)(ii)) should not disqualify the portfolio from tax-free treatment.
>
> The adoption of the modified section 368(a)(2)(F)(ii) test is intended to limit section 351(e) to cases more analogous to the typical swap fund cases that were the focus of the section 351(e) legislation. Also, the adoption of this test should minimize the different tax treatment of a section 351 transfer and a section 368 reorganization under economically similar situations.[78]

In reviewing the rationale set forth in the preamble, one is struck by the breadth of the solution the Treasury and Service adopted to what seems like a fairly narrow problem. The Treasury and Service did not, for example, seek to restrict the approach of including Government securities in the denominator but not in the numerator to the paradigm case of a fund consisting "mostly of Government securities," but rather applied it more generally. Perhaps the answer is that the Treasury and Service were, as suggested by the reference to limiting section 351(e) to "typical swap fund cases," relatively unconcerned about potential diversification of positions in Government securities.

An obvious corollary of this favorable treatment of Government securities is the potential for Government securities to be included along with other stock and securities to facilitate satisfaction of the diversification tests (*i.e.*, by driving up the denominator of the fraction and thereby reducing the percentage of the portfolio represented by other stocks or securities). It is presumably for this reason that the Treasury and Service included the limitation that this rule would not apply if "Government securities are acquired to meet the 25- and 50-percent tests." It is not clear to us that such a limitation is necessary or appropriate considering the mechanical nature of the Section 368(a)(2)(F) 25/50 Test. As described further below, pre-transfer acquisitions of assets to meet the test do not seem problematic, given that the transferor has already diversified prior to the transfer. If it is concluded, however, that Government securities require a special rule, we recommend the Treasury and Service clarify the scope of this limitation. Specifically, when the language says "acquired to meet the 25- and 50-percent tests," the question is "acquired by whom" – the transferor or the transferee corporation?

Consider a case in which a transferor is considering transferring to a newly formed corporation a portfolio of stocks worth $100, with five of those stocks comprising $51 of the total value, while other transferors will also be contributing diversified portfolios. The transferor also owns, "old and cold," $10 of Government securities. In order to meet the diversification standard, the transferor elects to include the $10 of Government securities along with the other securities, thereby reducing the five largest stock holdings to 46.3 percent of the portfolio. In this case, the transferor has not itself acquired Government securities to meet the 50-percent test. Rather, it has simply altered the composition of the contribution with securities it already owned. However, it might not be entirely clear that this satisfies the regulatory standard. In particular, it might be argued that, while the transferor has not acquired Government

[78] CO-19-95, 60 FR 40794.

securities to meet the 50-percent test, the transferee corporation has acquired the Government securities for that purpose – *i.e.*, it has accepted the Government securities as part of the contribution to enable all transferors to make tax-free transfers.

We submit that the Regulations should be clarified to make clear that the favorable Government securities rule under the Regulations is unavailable only when the transferor acquires the Government securities to meet the test. We believe such an interpretation is a fair and sensible reading of the regulatory language, and what we expect was the intent when that language was adopted. In particular, this interpretation is consistent with the regulatory authority under section 368(a)(2)(F)(iv) to exclude from consideration assets acquired for purposes of enabling a corporation to satisfy the Section 368(a)(2)(F) 25/50 Test or ceasing to be an investment company, the likely inspiration for the acquired Government securities rule in Treas. Reg. § 1.351-1(c)(6). That grant of regulatory authority logically can be interpreted to have potential application only to asset acquisitions by a corporation that occur prior to the transaction in which the corporation's status as diversified or as an investment company is relevant.[79] By analogy, the Government securities acquisition rule in the Regulations should be applied only to acquisitions undertaken by a transferor prior to a transaction to enable that transferor to possess a diversified portfolio that could be transferred to the transferee corporation.

Moreover, in cases such as the example described above, a potential transferor will have a number of options for altering the composition of the transferred portfolio to satisfy the test. Subject to possible business-side constraints, the transferor in the example could have gone the route of slightly reducing the amount of the top five stocks to be transferred, as opposed to adding Government securities to the transfer. Some degree of tailoring of transferred portfolios to meet the regulatory standard is to be expected in close cases, and having a test that focuses on whether the transferor newly acquires Government securities for the purpose of qualifying a transfer under section 351 is an administrable standard. By contrast, if the test were to turn on whether the transferee corporation acquires the Government securities to meet the diversification requirements, any contribution of a diversified portfolio in which Government securities are included and contribute to meeting the test could be called into question on the ground that some forethought was given to satisfying the diversification test at the time of the transfer, with the stakes under current law being the possible taxation of all transferors contributing assets to the newly formed corporation.

The question of interpretation of the acquired Government securities rule leads more naturally to the broader question of when, if at all, the Treasury should be concerned with acquisitions of assets to enable a transaction to satisfy the diversification requirements and avoid

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[79] The legislative history of the 1976 Act, which added section 368(a)(2)(F), states that "[t]he bill contains a . . . rule aimed at preventing manipulation of a company's assets in order to make one or more of the parties not an "investment company" (and therefore free of the bill's restrictions. As a result, the bill provides that assets acquired by a corporation for purposes of causing that corporation not to be an "investment company" are to be disregarded in determining whether that corporation is an investment company *before the transaction*. It is expected that specific rules for tax avoidance situations of this kind will be prescribed by the Internal Revenue Service." S. Rep. No. 938, Part 2, 94th Cong., 2d Sess. (1976); *General Explanation of the Tax Reform Act of 1976*, H.R. 10612, 94th Congress, Public Law 94-455, 94th Cong., 2d Sess. 665 (1976) (emphasis added).

being treated as a taxable transfer to an investment company. As an initial matter, insofar as Treas. Reg. § 1.351-1(c)(6) incorporates the Section 368(a)(2)(F) 25/50 Test for determining whether a transferred portfolio is diversified, application of Treas. Reg. § 1.351-1(c)(6) would be directly affected by any exercise of the Treasury's regulatory authority to exclude from total assets "assets acquired (through incurring indebtedness or otherwise) for purposes of meeting" the 25- and 50-percent tests. The Treasury has not, however, exercised this regulatory authority, and given the statutory language providing that the exclusion is to apply "under regulations prescribed by the Secretary," we do not believe this provision should be regarded as operative in the absence of implementing regulations.[80]

Revenue Ruling 88-32, although not dealing with the Section 368(a)(2)(F) 25/50 Test, suggests that the Service may be concerned in certain cases with pre-transfer acquisitions to enable transfers to qualify as not resulting in diversification. In Rev. Rul. 88-32, certain shareholders of Y corporation transferred their Y stock to X, a newly formed corporation. No assets other than Y stock were transferred to X. Pursuant to the plan to organize X, X sold significant amounts of Y stock in transactions in which X recognized gain or loss. The ruling holds that the transaction would not be treated as a taxable transfer to an investment company under section 351(e). The ruling reasons that,

> [t]he initial transfer of the Y stock to X did not result in diversification. The Y shareholders transferred identical assets (Y stock) to a newly organized corporation (X). Under section 1.351-1(c)(5) of the regulations, such a transfer is treated as not resulting in diversification unless it is part of a plan to achieve diversification in a series of non-recognition transactions. In the present situation, although the transferors acquire a more diversified investment than Y stock, by reason of X's subsequent sale of the Y stock and X's purchase of other marketable investments, this diversification does not occur in a transaction purporting to qualify for nonrecognition treatment. Thus, despite the economic diversification ultimately enjoyed by the transferors, their transfer of the Y stock to X does not result in diversification within the meaning of section 1.351-1(c)(1)(i) of the regulations.

Notably, in its statement of the facts, Rev. Rul. 88-32 stipulates that "[n]one of the transferors had acquired any of the Y stock transferred to X as part of the same plan to organize X."

As at least one commentator has observed, if the purpose of newly organized corporation X in Rev. Rul. 88-32 had been to continue to hold the Y stock transferred to it, whether certain transferors had acquired the Y stock shortly before or in connection with the transfers should not be a point of concern.[81] In such a case, there is no diversification for

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[80] *Cf.* CCA 201009013 (May 5, 2010) (concluding that section 336(e) is not self-executing). Moreover, the legislative history, quoted in the footnote immediately above, indicates that Congress envisioned that the Treasury would prescribe "specific rules for tax avoidance situations of this kind," suggesting that possibly not all assets acquired for the purpose of satisfying the diversification tests would be excluded from total assets.

[81] *See* Phillips, *Exchange Funds* at 199-17.

anyone: both the "old and cold" Y stock transferors and the "newly acquired" Y stock transferors continue to own an interest (albeit indirect rather than direct) solely in Y stock. Indeed, the analysis of such a fact pattern should be similar to that discussed above for cases in which one transferor contributes an undiversified position in a stock or security and another transferor contributes cash, with the intended use of the cash being to buy identical stock or securities.[82]

By contrast, if the intent were for the newly organized corporation to sell the newly acquired transferred assets and diversify, we would agree that there is a legitimate concern with pre-transfer acquisitions made to enable the transfers to qualify as not taxable under section 351(e). Consider the following example:

> *Example 7*: Karen contributes stock in corporation Y with a value of $30 to newly-formed corporation X in exchange for X stock. Pursuant to the same plan, Michael purchases $70 of Y stock on the market and contributes that Y stock to X. Shortly after the transfers, and again pursuant to the plan, X sells the $70 of Y stock received from Michael and uses the proceeds to acquire a diversified portfolio.

In such a case, the acquisition of the newly acquired stock is simply a temporary expedient to enhance the ability of the "old and cold" stockholders (Karen) to achieve diversification. The analysis should be the same as if Michael had contributed the $70 in cash, with the intended use of the cash being to acquire diversified assets, and the transfers should be treated as taxable transfers to an investment company.[83]

In cases in which each transferor is contributing a diversified portfolio of assets, it is less clear that pre-transfer acquisitions of assets to meet the Section 368(a)(2)(F) 25/50 Test are significant concerns. The very requirements of the Section 368(a)(2)(F) 25/50 Test imply that a transferor has to be already diversified to a considerable extent prior to the transfer, whether through the holding of historic positions or through recent purchases, and it may well be that one should not be concerned with further diversification of such portfolios. It is possible to conceive of "abusive" fact patterns – to take an extreme example, if the newly acquired assets were transferred to the corporation to enable the Section 368(a)(2)(F) 25/50 Test to be satisfied but shortly thereafter were distributed out to the shareholders. But outside of those types of circumstances, and acknowledging that it would leave open some limited potential opportunity for tax-free diversification, it may be the case that there need not be a limitation on acquisitions of assets by transferors to satisfy the Section 368(a)(2)(F) 25/50 Test and that the cause of certainty in the application of these rules would be advanced by taking such an approach.

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[82] *See supra* at Part IV.A.2.b.

[83] *See supra* at Part IV.A.2.b. As Barnet Philips notes, the concern may be lessened in the case of a transfer to a partnership because section 704(c) would result in any built-in gain from dispositions of the transferred securities being allocated back to the partner that originally contributed those securities. *See* Phillips, *Exchange Funds* at 199-18.

e. De Minimis Test

The De Minimis Test is an explicit exception to the rule that transfers by two or more persons of non-identical assets to a corporation ordinarily results in diversification. Under the De Minimis Test, if a transaction involves one or more transfers of non-identical assets that, in the aggregate, constitute an "insignificant portion" of the total value of assets transferred, those transfers are ignored for purposes of determining diversification.

An example in the Regulations provides the following:

> Example 8. A and B each transfer X stock worth $10,000 to a newly formed corporation for 50 shares of the corporation's stock, and C transfers $200 of Y stock for 1 share of the new corporation's stock.

The Regulation concludes that "C's participation in the transaction will be disregarded," presumably because the Y stock equaled 0.99 percent of the total assets transferred to the new corporation.[84] However, in Rev. Rul. 87-9, one transferor's contribution of cash amounting to 11 percent of the total assets was enough to cause a transferor of securities by the other transferor to be taxable.[85] These percentages illustrate what is perhaps the most intuitive means of calculating the non-identical component – look at entire pool of transferred assets, identify the minority asset and determine the percentage of the total transferred assets it comprises (the "Simplified De Minimis Methodology").

In PLR 200006008, a section 721(b) ruling, transfers of non-identical assets to an LLC were treated as insignificant for purposes of determining whether diversification exists. The non-identical assets constituted less than 5 percent of the total value of the assets transferred, but the ruling used a particular methodology for calculating the nonconforming assets (the "PLR Methodology"). Specifically, the ruling looked at each transferor's direct interest in each asset prior to the transfer and compared it to its indirect interest in the asset after the transfer. Then it added up the aggregate increases in value of the transferors' interests in each asset. The sum increase in value of the transferors' interests in each asset did not exceed 5 percent of the aggregate value of the LLC's assets immediately after the transfers.

> Example 9. Linda Kate transfers $100 of Y stock and Rosie transfers $15 of Y stock and $5 of X stock to a newly formed corporation.

Intuitively, many would assume that the only "non-identical" asset is the X stock, which is 4.167 percent of the total assets. But under the PLR Methodology, Linda Kate increased her (direct or indirect) interest in X stock by $4.167 (she owned no X stock before the transfer and $4.167 of X stock (83.333 percent of $5 of X stock) indirectly after the transfer) and Rosie increased her (direct or indirect) interest in Y stock by $4.167 (she owned $15 of Y stock before the transfer and $19.167 of Y stock (16.667 percent of $115 of Y stock) indirectly after the transfer. So the total increase in value of the transferors' interests in each asset is $8.334,

[84] Treas. Reg. § 1.351-1(c)(7), Ex. 1.
[85] Rev. Rul. 87-9, 1987-1 C.B. 133.

which is 6.944 percent of the total assets ($120). Essentially, the PLR Methodology is treating the disproportionate value of the Y stock as another non-identical asset.

Applying the PLR Methodology to the example in the Regulations (Example 8), A and B each increase their interest in Y stock by $99.01 (49.50 percent of $200) and C increases its interest in X stock by $198.02 (0.99 percent of $20,000). So the total increase is $396.04, which is 1.96 percent of the total assets ($20,200). This is in contrast to the Simplified De Minimis Methodology, which would conclude that only 0.99 percent of the assets are non-identical assets.

As noted above, the PLR Methodology may not be intuitive. We believe, however, that the PLR Methodology produces a more consistent result than merely evaluating the "different" asset (as in the Simplified De Minimis Methodology), because it measures the amount of diversification that the transferors collectively achieve. In instances where each transferor transfers an overlapping mix of assets, such an analysis may be necessary to distinguish the true extent to which diversification has occurred.

> _Example 10_. Eliza transfers $90 of Y stock and $10 of X stock, and Max transfers $15 of Y stock and $5 of X stock to a newly formed company.

The Simplified De Minimis Methodology would simply analyze the X stock as the non-identical asset. The X stock constitutes $15 of the $120 of assets transferred, or 12.5 percent. Such an analysis does not make sense, however, because both parties are transferring a mix of X and Y stock, so the amount of diversification is less than 12.5 percent.

Under the PLR Methodology, however, Eliza has gone from owning $90 of Y stock and $10 of X stock to having 83.33 percent of $105 of Y stock ($87.5) and 83.33 percent of $15 of X stock ($12.5). So she has diversified by $2.5 (a $2.5 increase in her X stock). Similarly, Max has gone from owning $15 of Y stock and $5 of X stock to having 16.67 percent of $105 of Y stock ($17.5) and 16.67 percent of $15 of X stock ($2.5). So he has also diversified by $2.5 (a $2.5 increase in his Y stock). There is a total diversification of $5, which is only 4.167 percent of the total assets ($120).

Accordingly, we believe that the PLR Methodology is more appropriate than the Simplified De Minimis Methodology.

A variation of the PLR Methodology would be to analyze the amount each transferor has diversified by comparing the amount by which it has diversified to its total assets (the "Transferor Specific Methodology"). Any transferor whose diversification exceeds a specified percentage would be treated as having diversified. For instance, in Example 10 above, Eliza has diversified by $2.5 (a $2.5 increase in her X stock) and has transferred $100 of assets, so her diversification percentage is 2.5 percent. Max has diversified by $2.5 (a $2.5 increase in his Y stock) and has transferred $20 of assets, so his diversification percentage is 12.5 percent. If the de minimis threshold were 5 percent, Max would be treated as having diversified, but Eliza would not. Unlike the PLR Methodology, the Transferor Specific Methodology would be consistent with allowing non-diversifying transferors to achieve a tax-free exchange under section 351 even if another transferor has diversified. See Part IV.A.2.a above. Therefore, we

recommend adopting the Transferor Specific Methodology if the Treasury and Service adopt a rule that provides that only a diversifying transferor recognizes gain or loss. If, however, the Treasury and Service do not adopt a transferor-by-transferor approach to the recognition of gain or loss under section 351(e), the Transferor Specific Methodology has the potential for very harsh results. For instance, in Example 10 above, because, under the Transferor Specific Methodology, Max's diversification percentage is 12.5 percent, Max would likely be treated as having diversified. If Max's diversification also taints Eliza's tax-free treatment, Eliza would be subject to tax even though Eliza has only diversified by 2.5 percent and the total diversification (under the PLR Methodology) is only 4.167 percent. As a result, if the Treasury and Service do not adopt a transferor-by-transferor approach to the recognition of gain or loss, we recommend that the PLR Methodology be adopted.

Although we recommend the adoption of the Transferor Specific Methodology or PLR Methodology, these approaches often provide little leeway for taxpayers, particularly in light of the overall purpose of section 351(e). Specifically, the PLR Methodology often produces a result that is higher than the intuitive result under the Simplified De Minimis Methodology. For instance, applying the PLR Methodology to the example in the Regulations (Example 8) produces 1.96 percent non-identical assets, rather than the 0.99 percent non-identical assets under the Simplified De Minimis Methodology. Accordingly, we recommend that the Treasury and Service consider a higher threshold than the 5 percent standard used in PLR 200006008. A 10 percent threshold, for instance, would be appropriate. If the transferors have not diversified by more than 10 percent, the purpose of section 351(e) – namely, to prevent the types of abuses exemplified by swap funds – would not appear to be at issue.

There is also some ambiguity about whether the De Minimis Test can apply in conjunction with the diversified portfolio rule. Both are exceptions to the general rule that a transfer of non-identical assets will result in diversification: the De Minimis Test disregards non-identical assets that are an "insignificant portion" of the total assets, while the diversified portfolio rule provides that a transfer will not result in diversification if each transferor transfers a diversified portfolio of stocks and securities.[86] If the two rules can operate together, it is unclear how to determine the quantity and quality of the non-identical assets for purposes of the De Minimis Test: how would the non-identical assets be identified (given that the other assets are a broad mix of securities)?

> Example 11. Amanda transfers $10 each of V, W, X, Y and Z stock, and Adam transfers $10 each of Q, R, S and T stock and $15 of U stock, to a newly formed corporation.

Absent the De Minimis Test and the diversified portfolio rule, the transferors are clearly diversifying. Amanda has transferred a diversified portfolio, but Adam has not met the Section 368(a)(2)(F) 25/50 Test, because the transferred U stock constitutes 27.27 percent of the portfolio. If Adam could treat $5 of U stock as an insignificant portion of the total assets and disregard it, Adam would also be treated as transferring a diversified portfolio. Using the

[86] Treas. Reg. § 1.351-1(c)(5) and (6).

Simplified De Minimis Methodology, that portion of the U stock would be de minimis, because it would constitute 4.76 percent of the total assets (5 divided by 105). However, as we have described above, we do not think that the Simplified De Minimis Methodology is an appropriate means of measuring an insignificant portion of the assets.

Suppose we were instead to apply the PLR Methodology to this Example. Presumably to make it work, one would need to treat the portion of the assets that would otherwise constitute a diversified portfolio as a single asset. So Amanda would be treated as transferring a diversified portfolio (worth $50) and Adam would be treated as transferring a diversified portfolio (worth $50) plus $5 of U stock. Amanda has gone from owning $50 of a diversified portfolio to having 47.62 percent of $100 of a diversified portfolio ($47.62) and 47.62 percent of $5 of U stock ($2.38). So she has diversified by $2.38 (a $2.38 increase in her U stock). Similarly, Adam has gone from owning $50 of a diversified portfolio and $5 of U stock to having 52.38 percent of $100 of a diversified portfolio ($52.38) and 52.38 percent of $5 of U stock ($2.62). So Adam has also diversified by $2.38 (a $2.38 increase in his diversified portfolio). There is a total diversification of $4.76, which is only 4.53 percent of the total assets ($105). Accordingly, if the De Minimis Test were applied in this manner, section 351(e) would not apply even though Adam's securities did not qualify as a diversified portfolio.

We think that layering the De Minimis Test on the diversified portfolio rule in this manner can lead to exceedingly complicated calculations and an inappropriate avoidance of the Section 368(a)(2)(F) 25/50 Test. Accordingly, we recommend that the Treasury and Service clarify that these are alternative exceptions to the general diversification rule.

f. Transfers to Oldcos

The Section 351(e) Diversification Test provides that section 351(e) may apply if the transfer results, directly or indirectly, in diversification of the transferors' interests. Accordingly, the Regulation's general statement of the rule is broad enough to encompass both transfers by multiple transferors to a newly formed corporation and transfers by one or more transferors to an existing corporation. The current Regulations, however, do not specifically address situations in which there are transfers to an existing corporation. Specifically, the Regulations provide that (i) diversification "ordinarily results" if two or more transferors transfer non-identical assets (and, under the De Minimis Test, non-identical assets are ignored for purpose of this rule if they are an insignificant portion of the assets transferred) and (ii) if there is only one transferor (or two or more transferors of identical assets) to a newly formed corporation, the transfer will generally not result in diversification. As noted above, under the Withdrawn Proposed Regulations, if there were any one transferor (or two or more transferors of identical assets) to an existing corporation, the transfer would have been treated as resulting in diversification unless the transferee's assets were identical to the assets transferred (with no de minimis exception). This regulation, which was withdrawn, was overbroad in that it would treat the following situation as resulting in diversification:

> *Example 12*. Rachel and Erik each initially own 50 percent of Corp, which owns $100 of X stock. Rachel and Erik each transfer $50 of Y stock to Corp.

Because the stock transferred is not identical to the stock already held by Corp, the Withdrawn Proposed Regulations would have treated the transfer as resulting in diversification. But, in actuality, each transferor's direct and indirect interests in assets have not changed. Accordingly, the transfer should not have resulted in diversification.

This Report makes a number of recommendations regarding transfers to existing corporations.[87] First, we recommend that the Treasury and Service adopt a rule that looks to a transferor's direct and indirect interest in assets before and after the transfer to see whether diversification has resulted. Specifically, the transferor's direct interest in the transferred assets and indirect interest in the transferee corporation's assets before the transfer should be compared with the transferor's indirect interest in the transferee corporation's assets after the transfer. The transferor should be treated as indirectly owning its pro rata share of any assets held by the transferee corporation, based on its percentage stock ownership (by value) of the corporation. For instance, in Example 12 above, Rachel and Erik each went from owning $50 of Y stock directly and $50 of X stock indirectly, to owning $50 of Y stock and $50 of X stock indirectly. Thus, diversification should not result. In contrast, in the following example the transferor has diversified:

Example 13. Corp holds $100 of X stock. Ray and Mike each initially own 50 percent of Corp. Ray transfers $200 of Y stock to Corp.

Ray is diversifying, because he goes from owning $50 of X stock and $200 of Y stock to owning $83.33 worth of X stock and $166.67 worth of Y stock.

In determining a transferor's indirect interest in assets held by the transferee corporation, we recommend that a look-through rule be established for entities owned by the transferee corporation. We recommend that the same look-through rules that are used for purposes of determining whether a corporation is a Section 351(e) Investment Company apply for this purpose as well.

Example 14. Corp holds a 50 percent interest in Partnership, which holds $100 of Y stock. Pamela and David each initially own 50 percent of Corp. Pamela transfers an additional $200 of Y stock to Corp.

Absent a rule that looks through Partnership, Pamela would be treated as diversifying. Before the transfer, Pamela held $200 of Y stock and $25 of Partnership interests indirectly. After the transfer, Pamela holds, indirectly, 83.33 percent of the $200 of Y stock ($166.67) and 83.33 percent of the $50 of Partnership interests ($41.67). Therefore, Pamela's interest in the Partnership increased by $16.67.

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[87] There are also a number of issues with respect to the application of section 721(b) to existing partnerships, including how the partnership is treated if there is a section 721(b) contribution. These issues, however, are beyond the scope of this Report.

Looking through the Partnership, however, it becomes clear that Pamela owned nothing but Y stock, directly or indirectly, before and after the transfer. As a result, Pamela should not be treated as having diversified.

Second, this Report recommends adopting a corresponding rule to the Section 368(a)(2)(F) 25/50 Test that applies for transfers to newly formed corporations. As noted above, if each transferor to a new corporation transfers a diversified portfolio of stocks and securities, the transfer will not be treated as resulting in a diversification.[88]

For transfers to existing corporations, we believe there should be a diversified portfolio rule that applies in two instances. First, we recommend the inclusion of a diversified portfolio rule that looks to both direct and indirect assets of the transferor immediately before the transfer. If, immediately before the transaction, the combination of (i) the assets the transferor is transferring and (ii) the transferor's pro rata share of the assets held by the transferee corporation would constitute a diversified portfolio, we recommend that the transferor's transfer to the corporation not be treated as resulting in diversification to that transferor. Here are two contrasting examples that illustrate the possible applications of this rule:

> *Example 15*. Corp holds a $100 diversified portfolio, with securities of 20 different issuers of $5 each. Debbie and Joel each initially own 50 percent of Corp. Debbie transfers an additional $200 worth of Y stock to Corp. Debbie is not treated as transferring a diversified portfolio, because Debbie has $250 of assets immediately before the transfer (the $200 of Y stock Debbie is transferring and the $50 diversified portfolio she owns indirectly), of which $200 (80 percent) is stock of a single issuer.
>
> *Example 16*. Corp holds a $100 diversified portfolio, with securities of 20 different issuers (none of which are X or Y) of $5 each. Ana and Mick each initially own 50 percent of Corp. Ana transfers $10 worth of Y stock and Mick transfers $10 worth of X stock. Ana and Mick are each treated as having a diversified portfolio because they are treated as having $60 worth of assets immediately before the transfer ($10 of X or Y stock and an indirect $2.5 interest in securities of 20 other issuers), the largest percentage of a single issuer is 16.67 percent (10 divided by 60) and not more than $30 worth of securities are invested in 5 or fewer issuers.

It is worth noting that in Example 16, Ana or Mick could have transferred her or his interest in Corp stock, plus the interest in the X or Y stock, to a newly formed corporation without recognizing gain under section 351(e). This is because, for purposes of determining a diversified portfolio, section 351 looks through the stock of a corporation that itself is an investment company holding a diversified portfolio. Accordingly, looking at both the direct and indirect interests of the transferor in determining a diversified portfolio seems appropriate. If the Treasury and Service wanted to make the rule entirely consistent with the look-through rule that

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[88] Treas. Reg. § 1.351-1(c)(6).

currently applies to diversified portfolios, it could provide that a transferor takes into account its indirect interests in the transferee corporation only to the extent that the transferee corporation already is an investment company holding a diversified portfolio, but that appears to us to be unnecessarily limiting.

Second, we recommend that the Treasury and Service also adopt a rule that treats the transfer of a diversified portfolio to an existing corporation as not resulting in diversification to the transferor (in the absence of a plan to achieve diversification).

> _Example 17_. Aiden and Maisie each initially own 50 percent of Corp, which has $200 of X stock. In an unrelated transaction to the prior contributions, Aiden transfers a diversified portfolio worth $25 to Corp, and Maisie transfers a diversified portfolio worth $75 to Corp.
>
> Aiden is diversifying his existing indirect interest in X stock, because he is going from owning a $25 diversified portfolio directly and $100 of X stock indirectly, to owning 41.67 percent of a $100 diversified portfolio ($41.67) and 41.67 percent of $200 of X stock ($83.34) indirectly. In addition, if we applied a diversified portfolio rule that takes into account both the transferor's direct and indirect interests (as described above), Aiden would not be treated as transferring a diversified portfolio, because Aiden has $125 of assets immediately before the transfer (the $25 diversified portfolio and the $100 of X stock it owns indirectly), of which $100 (80 percent) is stock of a single issuer. If, however, a diversified portfolio rule treated a transfer of a diversified portfolio as not resulting in diversification to the transferor, regardless of whether there is a diversification of the corporation's existing assets, Aiden would not be taxed on the transfer.[89]

This Example illustrates how difficult the analysis of diversification can be (particularly when dealing with existing corporations), given the fact that nearly every section 351 transaction is a diversifying transaction. We think that it does not make sense to tax transfers to a corporation because pre-existing assets of the corporation are being diversified. Otherwise, the gains that are being taxed have no relation to the assets that are being diversified. In addition, allowing a transfer of a diversified portfolio to be treated as a diversification of a corporation's existing assets provides for a very anomalous result: if Aiden transfers a diversified portfolio, Aiden can be taxed under section 351(e) because Aiden's share of the corporation's pre-existing assets have been diversified; but if Aiden is not a transferor in the transaction, and other transferors transfer diversified portfolios to the corporation, Aiden is not taxed, despite the fact that Aiden's share of the corporation's assets similarly have been diversified. Accordingly, we recommend the adoption of a diversified portfolio rule that allows transferors in a transaction to transfer diversified portfolios to an existing corporation.

[89] Note that in this example, Maisie is arguably becoming less diversified, not more diversified. Maisie is going from owning a $75 diversified portfolio directly and $100 of X stock indirectly, to owning 58.33 percent of a $100 diversified portfolio ($58.33) and 58.33 percent of $200 of X stock ($116.66) indirectly. In essence, Maisie has exchanged $16.66 of her diversified portfolio for stock of a single issuer.

Finally, we recommend that there be a comparable de minimis exception to the De Minimis Test, but such rule should only apply to the transferors in the transaction. The following example illustrates some of the alternatives for applying a de minimis exception.

> *Example 18*. Rachel, Mike, Ray, and Erik each initially own 25 percent of Corp, which owns $100 of Y stock. Rachel transfers an additional $25 of Y stock, Mike transfers an additional $20 of Y stock and $5 of X stock, and Ray transfers an additional $45 of Y stock and $5 of X stock.
>
> If a De Minimis Test were applied using the Simplified De Minimis Methodology, and this methodology were applied to all shareholders (including Erik), $10 of X stock would be non-identical, relative to $200 of total assets, which equals 5 percent.
>
> Using the Simplified De Minimis Methodology and excluding the non-transferor shareholder (Erik), there would be $10 of X stock out of a total of $175 in assets transferred (or indirectly owned by the transferors), which equals 5.714 percent.
>
> Using the PLR Methodology and applying the methodology to all shareholders (including Erik) produces the following result: Rachel increases her direct or indirect interest in X stock by $2.5 (she goes from owning $50 of Y stock, directly and indirectly, to owning 25 percent of $190 of Y stock ($47.5) and 25 percent of $10 of X stock ($2.5)); Mike increases his direct or indirect interest in Y stock by $2.5 (he goes from owning $45 worth of Y stock and $5 worth of X stock to owning 25 percent of $190 of Y stock ($47.5) and 25 percent of $10 of X stock ($2.5)); Ray increases his direct or indirect interest in Y stock by $1.25 (he goes from owning $70 of Y stock and $5 of X stock to owning 37.5 percent of $190 of Y stock ($71.25) and 37.5 percent of $10 of X stock ($3.75)); and Erik increases his direct and indirect interest in X stock by $1.25 (he goes from owning $25 of Y stock to owning 12.5 percent of $190 of Y stock ($23.75) and 12.5 percent of $10 of X stock ($1.25)). So the non-identical assets equal $7.5 divided by $200, which is 3.75 percent.
>
> Using the PLR Methodology and applying the methodology only to transferors (not Erik) produces the following result: Rachel increases her direct or indirect interest in X stock by $2.5 (she goes from owning $50 of Y stock, directly and indirectly, to owning 25 percent of $190 of Y stock ($47.5) and 25 percent of $10 of X stock ($2.5)); Mike increases his direct or indirect interest in Y stock by $2.5 (he goes from owning $45 worth of Y stock and $5 worth of X stock to owning 25 percent of $190 Y stock ($47.5) and 25 percent of $10 of X stock ($2.5)); Ray increases his direct or indirect interest in Y stock by $1.25 (he goes from owning $70 of Y stock and $5 of X stock to owning 37.5 percent of $190 of Y stock ($71.25) and 37.5 percent of $10 of X stock ($3.75)). So the non-identical assets equal $6.75 divided by $175 (the assets owned directly or indirectly by the transferors), which equals 3.86 percent.

Using the Transferor Specific Methodology produces the following result: Rachel increases her direct or indirect interest in X stock by $2.5 (she goes from owning $50 of Y stock, directly and indirectly, to owning 25 percent of $190 of Y stock ($47.5) and 25 percent of $10 of X stock ($2.5)), which is 5 percent of her total assets ($50); Mike increases his direct or indirect interest in Y stock by $2.5 (he goes from owning $45 worth of Y stock and $5 worth of X stock to owning 25 percent of $190 of Y stock ($47.5) and 25 percent of $10 of X stock ($2.5)), which is 5 percent of his total assets ($50); Ray increases his direct or indirect interest in Y stock by $1.25 (he goes from owning $70 of Y stock and $5 of X stock to owning 37.5 percent of $190 of Y stock ($71.25) and 37.5 percent of $10 of X stock ($3.75)), which is 1.67 percent of his total assets ($75).

We recommend that the PLR Methodology or Transferor Specific Methodology be used because, as described above, we believe that these methodologies best assess the actual diversification that is achieved by the transferors. The Transferor Specific Methodology, by its nature, looks to the diversification of each individual transferor and therefore potentially provides the cleanest method for assessing diversification in these situations, particularly if taxation under section 351(e) is determined on a transferor-by-transferor basis. We also believe that it is not appropriate to include the non-transferors in the analysis if the PLR Methodology is used: to the extent the non-transferors are diversifying, they will not be subject to tax. Accordingly, we believe that the extent to which non-transferors are diversifying should be irrelevant to the de minimis analysis. We note, however, that the decision to include or not include non-transferors in the PLR Methodology is not an easy one. Because a transferor's entire asset base (including its indirect interest in the corporation's assets) is included in the test even if the transferor transfers a very small amount of assets, there could be large discrepancies in the results, depending on whether a person is a non-transferor or a transferor of a tiny amount of assets. Finally, we also recommend that in determining a transferor's indirect interest in the transferee corporation's assets for purposes of the de minimis exception, a look-through rule be established for entities owned by the transferee corporation. We recommend the adoption of the same look-through rule described above for purposes analyzing diversification with respect to transfers to existing corporations.[90]

B. Section 368(a)(2)(F)

1. Section 368(a)(2)(F) Investment Company – Look-Through Rule

For purposes of determining whether a corporation is a Section 368(a)(2)(F) Investment Company, a parent corporation is treated as owning its ratable share of the assets of its 50 percent owned corporate subsidiaries.[91] The Section 368(a)(2)(F) Look-Through Rule was included in the Code by Congress. Therefore, it is not possible to modify the percentage ownership that allows for its operation. However, the other recommendations made above with respect to the Section 351(e) Look-Through Rule are equally applicable for section 368(a)(2)(F),

[90] Note that further thought would need to be given to the application of the de minimis exception to partnerships under section 721(b).
[91] Section 368(a)(2)(F)(iii).

and thus we recommend the adoption of similar rules for purposes of applying the Section 368(a)(2)(F) Look-Through Rule.

2. Section 368(a)(2)(F) Diversification – Look-Through Rule

The statutory text of Section 368(a)(2)(F)(ii) provides that, for purposes of determining whether an investment company is diversified, an investment company is treated as holding its proportionate share of the assets of any RIC, REIT, or diversified investment company in which the investment company is a stockholder.[92] Section 368(a)(2)(F)(ii) does not, however, expressly provide a subsidiary look-through rule applicable to entities other than RICs, REITs, or diversified investment companies. We believe that the Treasury and Service should issue guidance providing that a look-through rule for 50 percent or greater owned corporate subsidiaries will apply for purposes of determining whether an investment company is diversified under section 368(a)(2)(F)(ii).

When section 368(a)(2)(F) was originally enacted as part of the Tax Reform Act of 1976, it did not include any look-through rule for purposes of determining whether a corporation was diversified under section 368(a)(2)(F). However, the legislative history indicates that a "look-through rule similar to the rule used in defining an 'investment company' [should] also [be] used in determining whether an investment company is diversified."[93] The Withdrawn Proposed Regulations included the look-through rule envisioned by the legislative history to the Tax Reform Act of 1976 (that is, the rule used for determining whether a parent is an investment company under section 368(a)(2)(F)).[94]

In the technical corrections title of the Tax Reform Act of 1986, Congress adopted a rule providing that interests in RICs, REITs or diversified investment companies would not be treated as stock of "an issuer" that could cause an investment company to fail to be diversified under section 368(a)(2)(F).[95] Although the statutory language appeared to effectively treat the

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[92] Section 368(a)(2)(F)(ii).

[93] S. Rep. No. 938, Part 2, 94th Cong., 2d Sess. 4076, fn 699 (1976), supra note 37.

[94] *See* Prop. Regs. § 1.368-4(g), 46 Fed. Reg. 1744 (1/7/81), *withdrawn* by REG-116099-98, 63 Fed. Reg. 71047 (12/23/98). Under the diversification look-through rule set forth in the Withdrawn Proposed Regulations, stock or securities of an investment company's subsidiaries would be disregarded, and the investment company would be treated as owning a ratable share of each asset of each such subsidiary equal to the percentage of the fair market value of the stock of the subsidiary owned by the investment company. Prop. Regs. § 1.368-4(g)(1). An investment company would have been able to apply this look-through rule solely to subsidiaries with respect to which it owned, directly or indirectly, (i) fifty percent or more of the total combined voting power of all classes of the subsidiary corporation's voting stock or (ii) fifty percent or more of the fair market value of all of its outstanding shares. Prop. Regs. § 1.368-4(g)(2). Indirect ownership of lower-tier subsidiaries would have been determined by multiplying the percentages of stock owned in each corporation in the chain of ownership. Prop. Regs. § 1.368-4(g)(3).

[95] Tax Reform Act of 1986, P.L. No. 99-514, § 1879(l)(1) (1986). After the enactment of the Tax Reform Act of 1986, and before being amended in 1988, section 368(a)(2)(F)(ii) read as follows:

> A corporation meets the requirements of this clause if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer (other than stock in a regulated investment company, a real estate investment trust, or an investment company which meets the requirements of this clause (ii)), 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 (other than stock in a regulated

(footnote continued)

stock of any RIC, REIT or diversified investment company as a per se diversified asset, the legislative history suggests that Congress intended to adopt the look-through rule described in section 368(a)(2)(F):

> This provision is intended to permit an investment company to be treated as a diversified investment company only if it would be so defined if it were deemed to own its ratable share of the assets of any RIC, REIT, or diversified investment company in which it owns stock (without regard to whether its percentage ownership is 50 percent or more).[96]

In 1988, Congress amended section 368(a)(2)(F)(ii) by adopting the look-through rule currently in the statute.[97] The 1988 legislative history indicates that the statute was amended to conform the statutory language of section 368(a)(2)(F)(ii) to the legislative history of the Tax Reform Act of 1986.[98]

We believe the diversification look-through rule enacted in 1986, and amended in 1988, was intended to expand upon the diversification look-through rule envisioned by the legislative history to the Tax Reform Act of 1976 and reflected at the time of enactment in the Withdrawn Proposed Regulations.[99] More specifically, we believe that the rule adopted in 1986 and revised in 1988 was intended to offer relief to investment companies that, prior to 1986, were obligated to treat as undiversified assets all interests in less than 50 percent owned RICs, REITS and other diversified investment companies. In enacting such a rule, Congress did not intend to limit the greater than 50 percent-owned corporate subsidiary look-through rule that it had previously envisioned in the 1976 legislative history and which had been incorporated in the Withdrawn Proposed Regulations.[100]

Moreover, there appears to be no good policy reason not to have a look-through rule for greater than 50 percent owned subsidiaries, particularly since such a rule is applied under section 368(a)(2)(F)(iv) for purposes of determining whether a corporation meets the Section 368(a)(2)(F) 50/80 Test. Indeed, in certain cases, it is possible that the absence of such a subsidiary look-through rule for diversification testing purposes could result in an investment company being inappropriately classified as undiversified, and denying reorganization treatment

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(footnote continued)

> investment company, a real estate investment trust, or an investment company which meets the requirements of this clause (ii)). For purposes of this clause, all members of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as one issuer.

[96] S. Rep. No. 99-313, 99th Cong., 2d Sess. at § XVIII.G.19 (1986).

[97] Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, § 1018(q)(5)(A), (B).

[98] S. Rep't No. 100-445, 100th Cong., 2d Sess. 400 (1988).

[99] Note that the Service did not withdraw the proposed regulations under section 368(a)(2)(F) until 1998. REG-116099-98, 63 Fed. Reg. 71047 (12/23/98). When the regulations were withdrawn, the Treasury and Service described the regulation drafting project as "inactive," and did not indicate that the regulations were inconsistent with then-existing law. *Id.*

[100] *See, e.g.*, Letter of Daniel I. Halperin and Judith C. Dunn, *87 TNT 6-18* (comparing the statutory language adopted in 1986 to the approach described in legislative history in a letter to the Treasury Department and the Joint Committee on Taxation; the authors assume that each approach was intended to expand the existing diversification look-through rule to less than 50 percent owned RICs, REITs and diversified investment companies).

in cases when the relevant investment company primarily, but indirectly, holds diversified investment assets. In fact, if only the limited statutory look-through rule described in section 368(a)(2)(F)(ii) applies, a corporation could be treated as an undiversified investment company even when its only assets consist of stock in wholly-owned operating companies and diversified investment companies.

> *Example 19*. Target, a corporation that is diversified within the meaning of section 368(a)(2)(F)(ii), merges with Parent in a transaction described in section 368(a)(1)(A). Parent owns 100 percent of the stock of both Subsidiary 1 and Subsidiary 2. Seventy percent of the total value of Parent's assets consist of stock of Subsidiary 1, a corporation whose assets consist of a portfolio of investment assets meeting the section 368(a)(2)(F)(ii) diversification requirements. The other 30 percent of the total value of Parent's assets consist of the stock of Subsidiary 2. 60 percent of the value of the total assets of Subsidiary 2 are operating assets and 40 percent of the value of its total assets consist of a diversified portfolio of stock and securities held for investment that does not overlap with Subsidiary 1's portfolio. Parent is an investment company.[101] If, however, only the REIT/RIC/diversified investment company look-through rule set forth in section 368(a)(2)(F)(ii) applies, Parent would not be diversified, because 30 percent of the value of Parent's total assets would consist of the stock of one issuer (Subsidiary 2).

We do not believe that treating the transaction described in Example 19 as taxable furthers the policy goals of section 368(a)(2)(F), which is intended to prevent an undiversified investment company from diversifying its assets in a tax-free reorganization by combining with another investment company. In the Example, a diversified investment company merges with a holding company that owns the stock of two subsidiaries, but which is a diversified investment company when the assets of those subsidiaries are taken into account. Neither the shareholders of Target nor the shareholders of Parent are diversifying previously undiversified investments.[102]

[101] Under the investment company look-through rule, Parent would be treated as owning its ratable share (100 percent) of the assets of both Subsidiary 1 and Subsidiary 2. As a result, 82 percent of the value of Parent's total assets would consist of assets held for investment. (82 percent = 70 percent (the relative value of Subsidiary) * 100 percent (the percentage Subsidiary 1's assets that are held for investment) + 30 percent (the relative value of Subsidiary 2) * 40 percent (the percentage Subsidiary 2's assets that are held for investment)).

[102] As discussed above, the Section 368(a)(2)(F) 25/50 Test applies for purposes of the Section 351(e) Diversification Test (i.e., the transfer of an already diverse portfolio to a Section 351(e) Investment Company does not result in further diversification). For the reasons discussed above, we believe that the Treasury and Service should also issue guidance providing a look-through rule for 50 percent or greater owned corporate subsidiaries for purposes of determining whether a transferor transfers an already diverse portfolio in a section 351 exchange. While Reg. § 1.351-1(c)(6)(i) would likely incorporate any modifications to the Section 368(a)(2)(F) 25/50 Test (e.g., the provision of a look through rule for purposes of testing diversification) a specific rule (or a more specific cross reference) applicable to section 351(e) would provide certainty.

3. Common Control Exception

As noted above, under the Common Control Exception, section 368(a)(2)(F) does not apply, and tax-free reorganization treatment is not denied, when the stock of each investment company is owned substantially by the same persons in the same proportions. As the legislative history suggests, section 368(a)(2)(F)(v) leaves open several interpretive questions to be addressed by the Treasury and Service.[103] In this Part, we recommend that the Treasury and Service adopt two rules that would further the policy goals of the Common Control Exception: (1) an attribution rule and (2) rules describing permitted variations in the ownership of an investment company. The Withdrawn Proposed Regulations did not include an attribution rule to be used in connection with the Common Control Exception, but did include several examples intended to illustrate when substantial ownership in the same proportions existed.[104] The Withdrawn Proposed Regulations did not include an attribution rule for determining ownership of the stock of an investment company.

a. Attribution

The purpose of the Common Control Exception is to allow "reorganizations of commonly controlled investment companies to continue to be tax-free."[105] Absent an attribution rule, Congress' purpose would often be frustrated. For example, without an attribution rule, the Common Control Exception would not apply when investment companies indirectly owned by the same shareholder are involved in reorganizations that would otherwise be treated as tax-free reorganizations.

> *Example 20*. Parent owns 100 percent of the stock of each of X and Y. X owns 100 percent of the stock of Subsidiary X, an undiversified investment company. Y owns 100 percent of the stock of Subsidiary Y, an undiversified investment company. Subsidiary X merges into Subsidiary Y in a transaction described in section 368(a)(1)(A). Based on the limited statutory language of section 368(a)(2)(F)(v), no attribution rule applies such that Subsidiary X's merger into Subsidiary Y falls within the scope of the Common Control Exception.

We recommend that the Treasury and Service adopt the same attribution rule for purposes of the Common Control Exception that we recommend for purposes of the Section 351(e) Diversification Test.[106] The application of these principles would prevent the taxation of transactions that do not result in economic diversification, such as the following example.

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[103] *See* S. Rep. No. 938, Part 2, 94th Cong., 2d Sess. 4077 & fn. 702 (1976), supra note 37 (indicating that "detailed rules [are] needed to carry out the purposes of this exception").

[104] Prop. Regs. § 1.368-4(k)(1),(3). The Withdrawn Proposed Regulations also provided that in determining whether the common ownership exception applies, stock acquired for the purpose of meeting the requirements of the exception is disregarded. Prop. Regs. § 1.368-4(k)(2).

[105] S. Rep. No. 938, Part 2, 94th Cong., 2d Sess. (1976); *General Explanation of the Tax Reform Act of 1976 (H.R. 10612*, 94th Congress, Public Law 94-455), 94th Cong., 2d Sess. 665 (1976).

[106] *See* Part IV.A.2.c.

> *Example 21*. The facts are the same as Example 20. Pursuant to our recommendation, ownership of (i) X's stock in Subsidiary X is attributed to Parent and (ii) Y's stock in Subsidiary Y is attributed to Parent because all are members of the same "qualified group." Thus, 100 percent of the stock of each of Subsidiary X and Subsidiary Y would be treated as owned substantially by the same persons in the same proportions, and the Common Control Exception would apply.

b. Permitted Variations in Ownership

Another rule that we believe is necessary to implement the purposes of the Common Control Exception is a rule offering guidance as to the variations in stock ownership that are permitted under the Common Control Exception.

> *Example 22*. Parent owns 95 percent of the stock of X, an investment company, and 95 percent of Y, another investment company. A owns 5 percent of X and B owns 5 percent of Y. A and B are unrelated, and neither A nor B owns stock or securities of Parent. X merges into Y in a transaction described in section 368(a)(1)(A). Is the stock of each of X and Y owned substantially by the same persons in the same proportions such that the Common Control Exception applies?

We recommend the adoption of a bright-line rule that sets forth the amount of stock of two or more investment companies that must be owned by the same persons in the same proportions for the Common Control Exception to apply.

We believe that the Treasury and Service should adopt a rule allowing tax-free reorganizations when 90 percent or more of the stock of two or more investment companies is owned by the same persons in the same proportions. For these purposes, the extent of shareholders' common ownership would be determined as follows: first, a shareholder (or shareholders treated as one shareholder under the attribution rule proposed in Part IV.B.3.a) in two or more investment companies party to a reorganization would be treated as owning the percent of stock in each investment company equal to the lowest percentage of stock held by such shareholder in each investment company (the "Overlap Percentage"); second, the Overlap Percentage of each shareholder (or shareholders treated as one shareholder under the attribution rules) in the investment companies party to the reorganization would be added together. If the sum of all shareholders' Overlap Percentages exceeds 90 percent, the Common Control Exception would apply to the reorganization.

> *Example 23*. X and Y are investment companies, and Y acquires X's assets in a transaction described in section 368(a)(1)(C). A and B each own 50 percent of the fair market value of X's stock. A owns 45 percent of the stock of Y and B owns 55 percent of the stock of Y. The Common Control Exception would apply under the proposed rule, because A would be treated as holding 45 percent of the stock of both X and Y, and B would be treated as owning 50 percent of the stock of both X and Y. Under the proposed rule, 95 percent of the stock of both X and Y would be

owned by the same persons in the same proportions. As a result, the Common Control Exception would apply, and Y's acquisition of X's assets would qualify as a tax-free reorganization.

Alternatively, we believe the Treasury and Service should provide examples of variations in stock ownership that do and do not fit within the scope of the Common Control Exception. For example, the Treasury and Service could adopt regulations that include the examples illustrating permitted variations in stock ownership that were included in the Withdrawn Proposed Regulations[107]:

Assume in each of the following examples that X and Y are investment companies and that Y acquires X's assets in a transaction described in section 368(a)(1)(C).

> *Example 24*. A and B each own 50 percent of the fair market value of X's stock. A owns 52 percent and B owns 48 percent of the fair market value of Y's stock. The common ownership exception applies.
>
> *Example 25*. A and B each own 50 percent of the fair market value of X's stock. A owns 60 percent and B owns 40 percent of the fair market value of Y's stock. The common ownership exception does not apply.
>
> *Example 26*. A and B each own 48 percent of the fair market value of the stock of X and Y. C owns the remaining 4 percent of X, and D owns the remaining 4 percent of Y. The common ownership exception applies.
>
> *Example 27*. A and B each own 40 percent of the fair market value of the stock of X and Y. C owns the remaining 20 percent of X's outstanding stock and D owns the remaining 20 percent of Y's outstanding stock. The common ownership exception does not apply.

We believe that the policy goal of the Common Control Exception, which is to allow tax-free reorganizations of commonly controlled investment companies, would be furthered through the adoption of attribution rules for determining common stock ownership. We also believe that a bright-line rule rather than a test based on facts and circumstances may be preferable in that a bright-line rule would eliminate taxpayers' uncertainty as to the scope of the Common Control Exception. However, adopting a facts and circumstances test in conjunction with numerical examples such as those listed above would significantly reduce taxpayer uncertainty. Therefore, if the Treasury and Service decline to adopt a simple bright-line rule implementing the Common Control Exception, we recommend that the Treasury and Service adopt examples similar to those included in the Withdrawn Proposed Regulations.

[107] Prop. Regs. § 1.368-4(k)(3).