NEW YORK STATE BAR ASSOCIATION
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December 28, 2011

The Honorable Emily S. McMahon
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

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

Dear Ms. McMahon, Mr. Wilkins and Mr. Shulman:

We are pleased to submit New York State Bar Association Tax Section Report No. 1252. This report addresses issues that arise under sections 351(e) and 368(a)(2)(F) of the Internal Revenue Code (the "Code").

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." Other provisions of the Code adopt the principles of sections 351(e) and 368(a)(2)(F), including 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) if it were a corporation.

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. As discussed in the report, opportunities to achieve the results that led to the enactment of the investment company provisions continue under current law. 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.

Section 351(e) generally applies to exchanges where (i) the transfer results, directly or indirectly, in diversification of the transferor's interest 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 are comprised of stock, securities, or any of the assets listed in section 351(e), including money, a variety of financial instruments, and interests in certain entities. The report makes several recommendations related to both of these elements, including:

- Because Congress's list of 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" that would 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.

- If more than one transferor transfers property to a section 351(e) investment company and one such transferor achieves diversification, guidance should provide that the other transferor(s) should receive nonrecognition treatment, regardless of whether the non-diversifying transferor(s) satisfy the section 368(c) "control" test.

- With respect to cash, 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. In addition, published guidance should confirm that (i) a transfer of cash will not be treated as a diversifying transfer that causes otherwise qualifying transfers of 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.

- The ownership of subsidiary stock by related entities should be aggregated for purposes of determining whether the assets of a subsidiary should be treated as assets of its shareholder, and proposes a pure "look-through" rule for partnerships. In addition, the report proposes an attribution rule for purposes of determining whether diversification has been achieved.

- Current law does not adequately address the application of section 351(e) to old corporations. Thus, the report proposes that 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, with appropriate look-through rules. 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.

Under section 368(a)(2)(F), 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) (generally, (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). Section 368(a)(2)(F) does not apply if the stock of each corporation is owned substantially by the same persons in the same proportions (the "common control exception"). The report recommends that the attribution rules we propose for section 351(e) should be adopted for purposes of applying the section 368(a)(2)(F) "look-through" rule, and the "look-through" rule should apply for determining whether a corporation is diversified. In addition, we recommend that an attribution rule be provided for the common control exception.

We appreciate your consideration of the report and our recommendations.

Sincerely,

Jodi J. Schwartz

cc:

Erik H. Corwin
Deputy Chief Counsel (Technical)
Internal Revenue Service

William D. Alexander
Associate Chief Counsel (Corporate)
Internal Revenue Service

Stephen Larson
Associate Chief Counsel (Financial Institutions and Products)
Internal Revenue Service

Jeffrey Van Hove
Tax Legislative Counsel
Department of the Treasury

Lisa Zarlenga
Deputy Tax Legislative Counsel (Regulatory Affairs)
Department of the Treasury

Lee A. Kelley
Senior Counsel
Department of the Treasury

Michael S. Novey
Associate Tax Legislative Counsel
Department of the Treasury