

## Internal Revenue Service

Department of the Treasury

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### Legend:

Trust =

X =

Y =

n =

p =

q =

r =

s =

t =

u =

v =

Pursuant to a power of attorney on file in this office, this responds to your letters of March 8, 1999, and subsequent correspondence, setting forth the facts of the following transaction and requesting a ruling with respect to whether gain or loss will be recognized upon contributions of stock and securities to a new partnership under section 721.

### FACTS

X, Y, and Trust seek to contribute portfolios of stock to a newly formed limited liability company (LLC) that will be taxed as a partnership under §301.7701-3 of the Administrative and Procedure Regulations.

Trust will contribute a portfolio of stocks to LLC with an aggregate value of \$n, consisting of interests in p different stocks, v of which are stocks in regulated investment companies. X will contribute a portfolio consisting of r stocks with an aggregate value of \$q, s of which are stocks in real estate investment trusts. Y will contribute a portfolio of u stocks with an aggregate value of \$t, v of which are stocks in real estate investments trusts.

The taxpayer makes the following representations:

1. The sum total of all increases in value of X's, Y's and Trust's interests in each individual asset transferred to LLC does not exceed 5% of the aggregate value of LLC's assets immediately after the transfers. For purposes of this representation, the increase in value of a transferor's interest in any asset transferred to LLC is equal to the value of the transferor's indirect interest in the asset after the transfer less the value of the transferor's direct interest in the asset prior to the transfer. The value of the transferor's indirect interest in an asset is equal to the transferor's percentage ownership interest in LLC immediately after the transfer multiplied by the fair market value of the asset immediately after the transfer. The value of the transferor's direct interest in the asset it transferred is its fair market value at the time of transfer.

2. There is no plan or intention by any transferor to make any additional transfers to LLC.

3. Any other transferor who will contribute assets to LLC will not contribute assets in an amount or kind that would cause the total nonidentical assets transferred to LLC to be more than 5% of the aggregate amount of LLC's portfolio immediately after the transfer.

## **LAW AND ANALYSIS**

Section 721(a) provides that no gain or loss is recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 721(b) provides, however, that §721(a) does 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 §351) if the partnership were incorporated.

Section 1.351-1(c)(1) of the Income Tax Regulations states that a transfer to an investment company will occur when (i) the transfer results, directly or indirectly, in diversification of the transferors' interests and (ii) the transferee is a regulated investment company (RIC), a real estate investment trust (REIT), or a corporation more than 80% of the value of whose assets (excluding cash and non-convertible debt obligations from consideration ) are held for investment and are readily marketable

stocks or securities, or interests in RICs or REITs.

Section 1002 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997) (the "Act"), amends §351(e) for transfers after June 8, 1997, in taxable years ending after such date, subject to certain transitional relief provisions. Section 1002 of the Act is intended to expand the types of assets considered in determining whether a transfer is to a transferee described in §1.351-1(c)(1)(ii)(c) to include certain assets in addition to "readily marketable stocks or securities" and interests in RICs and REITs. However, the Act is not intended to alter the requirement of §1.351-1(c)(1)(ii) that a transfer of property will be considered to be a transfer to an investment company under §351(e) only if the transfer results, directly or indirectly, in diversification of the transferors' interests. See S. Rep. 105-33, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 131 (1997); H.R. Rep. 105-148, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 447 (1997); H.R. Rep. 105-220, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 516-17 (1997).

Section 1.351-1(c)(5) provides that a transfer ordinarily results in diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in the exchange. Additionally, if any transfer involves one or more transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, such transfers shall be disregarded in determining whether diversification has occurred. It further provides that, if a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification.

In this case, the facts involve transfers of nonidentical assets in an amount that is insignificant within the meaning of §1.351-1(c)(5). Accordingly, the transfers do not result in a diversification of the transferors' interests under §351(e).

## **CONCLUSION**

Provided LLC is treated as a partnership for purposes of §721, we conclude as follows:

1. The transfers of property by Trust together with the transfers of property by X and Y will not result in diversification. The transfers of nonidentical assets by the transferors, which amount to less than 5% of the total value of the assets transferred to LLC, are insignificant and therefore disregarded for purposes of determining whether diversification exists pursuant to §1.351-1(c)(5).

2. The transfers by Trust, X, and Y to LLC are not transfers of property to a partnership that would be treated as an investment company (within the meaning of

§351) if LLC were incorporated, provided that these are the only transfers to LLC (except for transfers that would not increase the percentage of nonidentical assets contributed over 5%).

We express no opinion on the tax treatment of the transaction described above under any other provision of the Code or regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction not specifically covered by the above ruling. In particular, we express no opinion as to: (i) the consequences of other transfers to LLC, either as to whether such other transfers would be “transfers to an investment company” or would, when taken together with the transfers by X, Y, and Trust cause those transfers to be considered “transfers to an investment company”, or (ii) whether the transfers are part of a plan to achieve diversification without recognition of gain under §1.351-1(c)(5).

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling letter have not yet been adopted. Therefore, this ruling will be modified or revoked if adopted temporary or final regulations are inconsistent with any conclusions in the ruling. See section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6. However, when the criteria in section 12.05 of Rev. Proc. 99-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is also being sent to a second authorized representative.

Sincerely,  
DAVID R. HAGLUND  
Senior Technician Reviewer, Branch 1  
Office of the Assistant Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)  
Copy of this letter  
Copy for section 6110 purposes