The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 11186

August 13, 1999

"SWAP FUND" TAX LEGISLATION INTRODUCED

1 Under present law, an investment company precluded from the nonrecognition of gain rules of Internal Revenue Code sections 351 and 721 is defined to include RICs, real estate investment trusts ("REITs") and any company if more than 80 percent of its assets is attributable to "stock and securities," as defined in section 351(e)(1)(B). 2 Under Treas. Reg. 1.351-1(c)(6), a portfolio will be treated as diversified if (i) not more than 25 percent of the portfolio's total assets are invested in the stock and securities of a single issuer and (ii) not more than 50 percent of the portfolio's total assets are invested in the stock and securities of five or fewer issuers. [11186] August 13, 1999 TO: TAX COMMITTEE No. 22-99 RE: "SWAP FUND" TAX LEGISLATION INTRODUCED

_____ House Ways and Means Committee Member Neal has introduced the attached bill (H.R. 2705) which would restrict the ability of investors to contribute appreciated assets on a tax-free basis to diversified investment pools known as "swap funds." The bill would apply to transfers made after "date of action" by the Ways and Means Committee (unless the transfer is pursuant to a written, binding contract in effect on August 3, 1999). Under the bill, the definition of an "investment company" – contributions to which may generate capital gain1 – would be modified in two significant respects. First, the bill would expand the types of assets considered in the definition of an investment company to include direct and indirect holdings of "any interest in an entity if the return on such interest is limited and preferred." As described in the attached floor statement, this change is intended to "shut down" a "tax loophole" that permits investors to transfer property on a tax-free basis to an entity holding at least 21 percent of its assets in real estate limited partnership interests. Second, the bill would create a new category of transfers that would be treated as made to an investment company. This additional category apparently is intended to prevent tax avoidance through the use of new types of swap fund transactions that may be created in the future. Proposed new section 351(e)(3) would treat a transfer of "marketable securities" as made to an investment company if the transferee is (1) "registered under the Investment Company Act of 1940 as an investment company, or is exempt from registration as a[n] investment company under section 3(c)(7) of such Act . . . " or (2) "formed or availed of for purposes of allowing persons who have significant blocks of marketable securities with unrealized appreciation to diversify those holdings without recognition of gain." Proposed new section 351(e)(3) appears to make no exception, like that provided under current Treasury regulations, for tax-free treatment of transfers of already diversified asset portfolios.2 If the bill were enacted in its current form, for example, two RICs with diversified portfolios of appreciated marketable securities apparently could not transfer those portfolios to a master fund partnership (registered under the Investment Company Act of 1940) on a tax-free basis. ACTION REQUESTED: Please provide any comments regarding "technical issues"

presented by the bill to the undersigned at 202 371-5436 or dflores@ici.org no later than Monday, August 23, 1999. Deanna J. Flores Assistant Counsel Attachment

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