

MEMO# 4641

March 29, 1993

IRS PRIVATE LETTER RULING ON DIVERSIFICATION IN FORMATION OF MULTITIER INVESTMENT COMPANIES WITH DIFFEREING ASSETS

March 29, 1993 TO: TAX COMMITTEE NO. 16-93 ACCOUNTING/TREASURERS COMMITTEE
NO. 16-93 RE: IRS PRIVATE LETTER RULING ON DIVERSIFICATION IN FORMATION OF
MULTITIER INVESTMENT COMPANIES WITH DIFFEREING ASSETS

In the attached, recently released private letter ruling (PLR 9310019), the Internal Revenue Service (the "Service") has ruled that no gain or loss will be recognized to either (1) a regulated investment company ("RIC") which contributes appreciated and/or depreciated assets to a partnership in exchange for interests in the partnership or (2) the partnership which receives those assets, even though other persons are known to be intending to contribute nonidentical assets to the partnership at a later time. The ruling states that no opinion will be given regarding the application of the Internal Revenue Code ("Code") to any other transactions which may be entered into by the RIC or the partnership. The RIC is one of 12 RICs in a series fund and the partnership is one of 12 partnerships in a second series fund. Each of the 12 RICs will contribute substantially all of its assets to the partnership with an investment objective corresponding to that of the RIC. The sponsor has represented that other investors intend to contribute assets to the partnership, and that all allocations of taxable income, gain, loss, and deduction will conform to the requirements of Code sections 704(b) and 704(c), and the regulations thereunder. The RIC has represented that the diversification requirements of Code sections 851(b)(4) and 368(a)(2)(F)(ii) were met by the RIC when the ruling was requested and will be met immediately before the transaction is implemented. The partnership states that it will meet those same requirements after the contribution of assets as if the partnership were a RIC. In addition, the ruling indicates that each future contributor of non-cash assets to the partnership will either (1) meet the diversification requirements of Code section 368(a)(2)(F)(ii) or (2) be a RIC, and each contribution of non-cash assets will be a portfolio of securities which meets the diversification requirements of Code section 368(a)(2)(F)(ii). Code section 721(a) provides that, generally, no gain or loss will be recognized to either a partnership or any of its partners upon the contribution of property to the partnership in exchange for an interest in the partnership. Code section 721(b), however, states that gain, if any, will be recognized if the transfer is to a partnership which would be treated as an investment company as defined in Code section 351 if the partnership were a corporation. Treasury Regulation section 1.351-1(c)(1) provides that a transfer will be a transfer to an investment company if the transfer results

in the diversification of the transferor's interest and the transferee is either a RIC or a corporation more than 80% of whose assets are readily marketable securities held for investment. Treasury Regulation section 1.351-1(c)(5) states that diversification ordinarily occurs when two or more persons transfer nonidentical assets in an exchange, regardless of whether the transfers occur simultaneously or as part of a plan in existence at the time of the transfer. Thus, Code section 721(b) provides, in effect, that if two persons, simultaneously or as part of a plan, transfer nonidentical assets to a partnership which would be a RIC if it were a corporation, that transfer would result in diversification and the partnership would thus be an investment company, making the transfer taxable, even if both of the portfolios transferred to the partnership were already diversified within the meaning of Code section 368(a)(2)(F)(ii). In the situation set forth in the private letter ruling the Service ruled that, despite the fact that the contributions of the RIC and the future partners to the partnership would not be identical, Code section 721(b) would not apply to the transfer to a partnership of assets of RICs which were already diversified within the meaning of Code section 368(a)(2)(F)(ii). We will keep you informed of further developments. David J. Mangefrida Jr. Assistant Counsel - Tax Attachment

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