Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact: 199909045

Telephone Number:

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November 30, 1998

Legend

Company =

Original Fund =

New Fund I =

New Fund II =

State =

Date 1 =

Date 2 =

Date 3 =

Dear

This letter responds to a request dated March 13, 1998, and additional submissions on behalf of Company, for rulings under § 721(a) and § 721(b) of the Internal Revenue Code.

FACTS

Company is the sole general partner of Original Fund, a State limited partnership. Original Fund began operations on

Date 1 and is (and always has been) classified as a partnership for federal income tax purposes. Original Fund was organized to make investments in all types of stocks and securities as well as a wide variety of rights related to stocks and securities.

Company subsequently formed New Fund I, also a State limited partnership. Company is the sole general partner of New Fund I. The initial limited partners of New Fund I were certain former limited partners of Original Fund. At the close of business on Date 2, Original Fund distributed to these limited partners their shares of the Original Fund assets and cash in complete liquidation of their Original Fund interests. Immediately thereafter, each of the initial limited partners transferred to New Fund I all of these assets in exchange for limited partnership interests in New Fund I. It has been represented that the assets are considered diversified under § 1.351-1(c)(6)(i) of the Income Tax Regulations.

Company intends to allow additional limited partners in Original Fund to also make such transfers in the future; however, it has been represented that such transfers will consist only of cash and/or portfolio interests that would also be considered diversified within the meaning of § 1.351-1(c)(6)(i). As part of the plan of contribution, Company intends to market limited partnership interests in New Fund I to other investors solely in return for cash contributions. Pursuant to this plan, limited partnership interests in New Fund I were obtained by investors solely for cash on Date 3.

Company intends to replicate this transaction in forming New Fund II, another State limited partnership. The initial limited partners of New Fund II will again be existing limited partners of Original Fund who receive their shares of Original Fund assets and cash in liquidation of their partnership interests. These limited partners will then transfer the assets and/or cash to New Fund II in exchange for limited partnership interests. Again it has been represented that these contributions will consist solely of cash and/or portfolio interests that would be considered diversified within the meaning of § 1.351-1(c)(6)(i). The formation of New Fund II will be substantially similar to the formation of New Fund I, except that the limited partners in New Fund II will be tax-exempt investors. After formation, Company will also market limited partnership interests in New Fund II solely in return for cash contributions.

Company has represented that to the best of its knowledge, there is no plan or intention for any transferor to transfer assets other than cash and/or a diversified portfolio of stocks and securities to New Fund I or New Fund II. For these representations, a portfolio of stocks and securities is diversified under § 1.351-1(c)(6)(i) if it satisfies the 25- and

50-percent tests of § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F), except that in applying § 368(a)(2)(F)(iv), Government securities are included in determining total assets unless Government securities are acquired to satisfy the requirements of § 368(a)(2)(F)(ii).

RULINGS REQUESTED

For the transaction described, the following rulings have been requested:

1. Section 721(b) will not apply to the transfers by the initial New Fund I limited partners at the close of business on Date 2 of their pro-rata shares of the assets of Original Fund.

2. Under § 721(a), no gain or loss will be recognized by the initial limited partners of New Fund I or by New Fund I on the contribution by such partners as of the close of business on Date 2 of their respective pro-rata shares of each of the assets of Original Fund to New Fund I in exchange for limited partnership interests in New Fund I.

3. For § 721, contributions solely of cash by investors to New Fund I and/or New Fund II in exchange for limited partnership interests in New Fund I and/or New Fund II will not cause former Original Fund limited partners, who transfer to New Fund I and/or New Fund II a diversified portfolio of stocks and securities (within the meaning of § 1.351-1(c)(6)(i)) representing their pro-rata shares of each of the assets of Original Fund, to be treated as transferring property to a partnership that would be treated as an investment company (within the meaning of § 351) if the partnership were incorporated.

LAW AND ANALYSIS

Section 721(a) provides that no gain or loss shall be recognized by a partnership or by 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 that § 721(a) shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of § 351) if the partnership were incorporated.

Section 1.351-1(c)(1) 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 percent 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) 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)(i) 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, 105th Cong., 1st Sess. 131 (1997); H.R. Rep. 105-148, 105th Cong., 1st Sess. 447 (1997); H.R. Rep. 105-220, 105th Cong., 1st 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. 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.

Section 1.351-1(c)(6)(i) provides that a transfer of stocks and securities will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities and a portfolio of stocks and securities is considered to be diversified if it satisfies the 25- and 50-percent tests of § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F), except that Government securities are included in total assets for purposes of the denominator of the 25- and 50-percent tests (unless 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.

An investment company is diversified within the meaning of § 368(a)(2)(F)(ii) if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total

assets is invested in the stock and securities of five or fewer issuers.

CONCLUSION

After applying the relevant law to the representations submitted, we hold as follows:

1. Section 721(b) will not be applicable to the Date 2 transfer by the initial New Fund I limited partners to New Fund I because New Fund I would not have been treated as an investment company (within the meaning of § 351) if it had been incorporated.

2. Under § 721(a), no gain or loss will be recognized by the initial limited partners of New Fund I or by New Fund I, on the Date 2 contribution.

3. Contributions solely of cash by investors in New Fund I or New Fund II in exchange for limited partnership interests, as described above, will not cause former Original Fund limited partners who transfer to New Fund I or New Fund II a diversified portfolio of stocks or securities (within the meaning of § 1.351-1(c)(6)(i)) representing their pro rata shares of each of the assets of Original Fund to be treated as transferring property to a partnership (New Fund I or New Fund II) that would be treated as an investment company (within the meaning of § 351) if the partnership were incorporated.

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 on (1) the consequences of other transfers to New Fund I or New Fund II, either as to whether such other transfers would be "transfers to an investment company" or would (except for transfers solely of cash), when taken together with the above referenced transfers by Company, the initial New Fund I partners, or future Original Fund partners that invest in New Fund II, cause those above referenced transfers to be considered "transfers to an investment company," (2) whether the above referenced transfers are part of a plan to achieve diversification without recognition of gain under § 1.351-1(c)(5), and (3) whether any transferor will transfer assets to New Fund I or New Fund II that would be considered diversified under § 1.351-1(c)(6)(i).

In addition, no opinion is expressed about any partnership allocations under § 704(b) or § 704(c), the classification of any

entity as a partnership for federal tax purposes, or the proper tax treatment of any liquidating distributions made to Original Fund investors.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file in this office, copies of this letter will be sent to Partnership's authorized representatives.

Sincerely yours,

(signed) Jeff Erickson

Jeffrey A. Erickson
Assistant Branch Chief,
Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and Special
Industries)

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