Reasons for Change

The IRS wants to clarify that §1.351-1(c)(5) does not prevent tax-free combinations of already diversified portfolios, and that combinations of already diversified portfolios are not inconsistent with the purposes of section 351(e) (i.e., preventing the taxfree transfer of one or a few stocks or securities to swap funds). For example, RICs often transfer portfolios of investment assets to partnerships under section 721(a) (which is subject to the section 351(e) rules pursuant to section 721(b)). These transactions are appropriately tax-free because the RICs are not transferring one or a few stocks or securities, but rather, the RICs are transferring diversified portfolios of stocks and securities.

Also, the nonidentical asset standard of \$1.351-1(c)(5) is stricter than the test applied for combinations of investment companies under the corporate reorganization provisions (see section 368(a)(2)(F)(ii)). Transfers of certain diversified portfolios to a corporation may be taxable under section 351(e), while the same portfolios could be combined through a merger that may qualify as a tax-free reorganization.

Explanation of Provisions

The proposed amendments to \$1.351-1(c) provide that transfers of assets will not be treated as transfers that result in diversification of the transferors' interests for purposes of \$1.351-1(c)(1)(i) if each transferor transfers assets that satisfy section 368(a)(2)(F)(ii), as modified. Under this rule, no transfers of nonidentical assets to a corporation described in §1.351-1(c)(1)(ii) will qualify for nonrecognition treatment under section 351 unless each transferor transfers assets that satisfy section 368(a)(2)(F)(ii), as modified.

For purposes of $\S 1.351-1(c)$, relevant provisions of section 368(a)(2)(F) will apply to the section 368(a)(2)(F)(ii) test. Those provisions include the controlled group and look-through rules found in clause (ii) (members of a controlled group of corporations are considered as one issuer and persons holding stock in certain investment companies are treated as holding a proportionate share of the investment company's assets), the common ownership rule found in clause (v) (diversification will not be considered to occur if the interests in the assets to be transferred are held substantially by the same persons in the same proportions as the interests in the transferee), and the definition of securities found in clause (vii) (the term securities includes investments

constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a-2(36)). The definition of total assets in section 368(a)(2)(F)(iv) will apply, except that Government securities will be included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

The proposed modification of the definition of total assets to include Government securities addresses a problem caused by transfers of funds consisting mostly of Government securities. For example, if 95 percent of a money market fund's assets are invested in Government securities and five percent are invested in the stock of corporation X, the Government securities would not be treated as securities (see section 368(a)(2)(F)(vii)) and, without the modification, would be excluded from total assets for purposes of the 25 and 50 percent test of section 368(a)(2)(F)(ii). As a result, the unmodified test would treat 100 percent of the fund's assets as X stock and the fund would not satisfy the 25 and 50 percent test of section 368(a)(2)(F)(ii). The modified test would include Government securities in total assets. The fund would satisfy the modified test because the stock of one issuer would constitute only five percent of the fund's portfolio. The IRS believes that the modification is appropriate because the presence of a small amount of nondiversified property in a Government securities portfolio (otherwise qualifying under section 368(a)(2)(F)(ii)) should not disgualify the portfolio from tax-free treatment.

The adoption of the modified section 368(a)(2)(F)(ii) test is intended to limit section 351(e) to cases more analogous to the typical swap fund cases that were the focus of the section 351(e) legislation. Also, the adoption of this test should minimize the different tax treatment of a section 351 transfer and a section 368 reorganization under economically similar situations. This test will also apply for purposes of sections 683(a) and 721(b). Finally, a proposed revision to §1.584–4(a) adopts this test.

Proposed Effective Date

These regulations are proposed to apply to transfers of assets occurring on or after the date of publication as final regulations in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has

been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these regulations is Andrew M. Eisenberg, Office of Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 as proposed to be amended in a document published elsewhere in this issue of the Federal Register continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * * Section 1.351–1 also issued under 26 U.S.C. 351 * * *.

Par. 2. Section 1.351–1 is amended by:

1. Redesignating paragraph (c)(6) as paragraph (c)(7).

2. Adding new paragraph (c)(6) to read as follows:

§1.351–1 Transfer to corporation controlled by transferor. *

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