A Loose End: Investment Companies

The nonrecognition rule of Section 721(a) doesn't apply to gain realized on a transfer of property to a partnership that would be treated as an investment company if the partnership were a corporation. IRC § 721(b). The term "investment company" comes from the corporate tax provision that is analogous to Section 721, namely Section 351. The investment company rule is in Section 351(e): "This section [providing nonrecognition] shall not apply to… [a] transfer of property to an investment company."

Section 351(e) never gets around to defining "investment company," but the regulations do. Reg. § 1.351-1(c)(1) provides in part:

> A transfer of property after June 30, 1967, will be considered to be a transfer to an investment company if—
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> (i) The transfer results, directly or indirectly, in diversification of the transferors' interests, and
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> (ii) The transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.

Under this definition, it was pretty easy to avoid "investment company" status: Just make sure that the corporation (or partnership) is not mutual fund (that's what a regulated investment company is), is not a "REIT" (which is like a mutual fund, only with real estate), and doesn't have more than 80 percent of its noncash assets tied up in marketable securities, mutual fund shares, or REIT shares.

However, after this regulation had been on the books for a long time, Congress added the second sentence of Section 351(e), which makes quite a few other types of assets off-limits under the 80 percent test: *all* stock and securities held by the company; cash (including foreign currency); evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives; interests in common trust funds or publicly traded partnerships; or any other property that is readily convertible into, or exchangeable for, any asset just described. Because that's such a broad array of assets (even cash is tainted), a corporation or partnership could inadvertently stumble into investment company status more easily than before.

So should taxpayers worry about this? To avoid the problem, all the partners or shareholders have to do is make sure that at the time of the exchange for which nonrecognition is desired, at least 20 percent of the company's assets are operating assets: equipment, real estate, inventory, that sort of thing. If the company's getting close to the 80 percent line, and a partner or shareholder is about to contribute cash, have them buy something that the company needs to operate, and contribute that instead.

And even if more than 80 percent of the company's assets are forbidden assets, the exchange still doesn't run into investment company troubles unless it "results, directly or indirectly, in diversification of the transferors' interests." It's never been clear what this means, beyond what the dictionary might reveal, but if there are only, say, two partners or shareholders, it seems unlikely that "diversification" could occur.