Transfer of Stock Portfolio to LLC Was Not Taxable

In many instances, property can be contributed to an entity by its owners in exchange for ownership interests, without gain or loss being recognized on the contribution. For partnerships and LLCs, the general rule under Sec. 721(a) states that "no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." This section, however, contains a lesser-known exception to the rule. This rule may create unintended consequences for taxpayers who do not properly consider them when transferring appreciated property to an entity as an investment company.

In Ltr. Rul. 200931042 , the IRS concluded that contributions of cash and/or a diversified portfolio of stocks in exchange for a partnership interest did not trigger the gain recognition rules applicable to investment companies.

Facts. An LLC was formed for the purpose of lowering investment costs and creating greater investment opportunity for the members. The LLC executed an amended agreement under which the LLC admitted five new members, each of whom made capital contributions to the LLC in exchange for membership interests. Further, certain original members made additional capital contributions in exchange for additional membership interests.

With respect to the anticipated capital contributions, the LLC represented to the IRS that (1) both new and original members contributed solely cash and/or a diversified portfolio of stock and securities to the LLC, (2) the LLC had no plan or intention for any members to transfer assets other than cash and/or a diversified portfolio of stocks and securities to the LLC, and (3) any other transferor who previously contributed or will in the future contribute assets to the LLC has contributed or will contribute solely cash and/or a diversified portfolio of stocks and securities to the LLC. The LLC further represented that the portfolio of stocks and securities to be contributed would be "diversified" within the meaning of Section 368(a)(2)(F)(ii) .

The LLC sought a ruling concerning the federal income tax consequences of the contribution of property to the LLC.

IRS analysis. The Service began by observing that Section 721(a) generally provides that neither a partner nor a partnership recognizes gain or loss as a result of a contribution of property in exchange for a partnership interest. Nevertheless, Section 721(b) clarifies that this general nonrecognition rule does not apply to transfers of property to a partnership that would be treated as an investment company, within the meaning of Section 351 , if the partnership were incorporated. Under Reg. 1.351-1(c)(1) , a transfer to an investment company occurs when two elements are met:

> (1) The transfer results, directly or indirectly, in diversification of the transferors' interests.
> (2) The transferee is a regulated investment company, real estate investment trust, or a corporation more than 80% of the value of whose assets (excluding cash and nonconvertible debt obligations) are held for investment and are readily marketable stocks or securities, or interests in RICs or REITs.

The IRS further explained that a transfer results in diversification of the transferors' interests if two or more persons transfer non-identical assets to a corporation in the exchange. Under Reg. 1.351-1(c)(5) , a transfer also results in diversification of the transferors' interests where the transfer is part of a plan to achieve diversification without recognition of gain, such as a plan that 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.

The Service also noted, however, that a transfer of stocks and securities is not treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities. A portfolio of stocks and securities is considered diversified if it satisfies the 25% and 50% tests of Section 368(a)(2)(F)(ii) , that is, no more than 25% of the portfolio's total asset value can be invested in the stock and securities of one issuer. Further, no more than 50% of the portfolio's total asset value may be invested in the stock and securities of five or fewer issuers. (See Reg. 1.351-1(c)(6)(i) .)

The LLC members in Ltr. Rul. 200931042 proposed to contribute stock and security portfolios that satisfied the 25% and 50% tests of Section 368(a)(2)(F)(ii) . The IRS ruled that such transactions would not be treated as transfers to an investment company within the meaning of Section 351 . The Service further determined that neither the members nor the LLC would recognize gain or loss as a result of the transactions. The IRS declined to opine as to whether the proposed transaction was part of a plan to achieve diversification under Reg. 1.351-1(c)(5) .

Implications. A taxpayer who wishes to diversify investment holdings ordinarily pays the price of immediate gain recognition. By following the guidance in Ltr. Rul. 200931042 , however, a taxpayer could diversify investment holdings and defer gain recognition without running afoul of the investment company rules.

These rules are especially important to keep in mind for those of your clients interested in transferring marketable security accounts to LLCs to achieve additional asset protection. Care must be taken to avoid the investment company rules so that the transfer will be income tax free.