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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01 – PLR-154244-03
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Legend:

P =

Family =

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T1 =

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b =

c =

d =

Dear :

This letter responds to the letter dated September 3, 2003, and related correspondence, written on behalf of P, requesting certain rulings under § 704(c) of the Internal Revenue Code ("Code") and the regulations promulgated thereunder.

FACTS

The information submitted discloses that certain members of the Family are the beneficiaries of the trusts, T1 through T58. Each of the trusts owned a portfolio of publicly traded stocks and securities in various corporations.

To centralize control and management of the investment of publicly traded stocks, the Family conducted the following transactions: On D1, certain members of the Family contributed a diversified portfolio of securities (not currently owned by the trusts) to LLC, a State limited liability company (taxable as a partnership for federal tax purposes). Immediately thereafter, LLC transferred the securities contributed by the

members of the Family and $ *a* of cash to P, a State limited partnership, in exchange for a general partner interest. Also on D1, the trusts contributed the publicly traded stocks to P in exchange for limited partner interests. As of D1, the trusts owned qualified financial assets in total value of $ *b,* with an aggregate gross built-in gain of $ *c* and aggregate built-in loss of $ *d.*

P represents that it will be treated as a partnership for federal income tax purposes under §§ 761(a) and 7701(a)(2). Its agreement was drafted with the intent to comply with §§ 704(b) and 704(c). It requires that a separate capital account be established and maintained for each partner in accordance with the capital account maintenance rules of § 1.704-1(b)(2)(iv). The agreement requires that on liquidation of P (or any limited partner's interest in P), liquidating distributions are to be made in accordance with the capital account balances of the partners. The agreement also contains a qualified income offset, as defined by § 1.704-1(b)(2)(ii)(d). Except as required by § 704(c), items of profit or loss are allocated in accordance with the partners' relative capital account balances.

Additionally, the agreement provides that the capital accounts of the partners will be increased or decreased to reflect a revaluation of the property of P on P's books upon the occurrence of a revaluation event. Revaluation events include:

> a) A contribution of money or other property (other than a *de minimis* amount) to P by a new or existing partner as consideration for an interest in P;
>
> b) The liquidation of P or a distribution of money or other property (other than a *de minimis* amount) by P to a retiring or continuing partner as consideration for an interest in P; and
>
> c) The end of each quarter in accordance with generally accepted industry accounting practices.

P will make revaluations at least annually in accordance with § 1.704-3(e)(3)(iii)(B)(*2*)(*ii*).

P expects to hire various managers to actively manage the investments. Each manager will manage their portfolio and make decisions about selling and buying securities based on their perception of opportunities in their sector. Thus, P expects to have significant turnover in the composition of its portfolio.

Further, P represents that it qualifies as a "securities partnership" as defined in § 1.704-3(e)(3)(iii). The contribution of cash and the diversified portfolio of securities to P was not taxable under § 721(b). The stock contributed to P is actively traded within the meaning of § 1.1092(d)-1. For purposes of making reverse § 704(c) allocations, P will adopt the partial netting approach as described in § 1.704-3(e)(3)(iv). All § 704(c)

and reverse § 704(c) allocations made under the partial netting approach will at all times comply with § 1.704-3(e)(3)(vi). P will consistently apply the same aggregate approach to all of its qualified financial assets for all taxable years in which P qualifies as a securities partnership. The partial netting approach adopted by P will preserve the tax attributes of each item of gain or loss realized by P. Each person that owns an interest, directly or indirectly, in P is currently subject to federal income tax at the highest applicable tax rate. Further, each such person expects to continue to be subject to federal income tax at the highest applicable tax rate.

Finally, P represents that contributions or revaluations of property and the corresponding allocations of tax items by P will not be made with a view to shifting the tax consequences of built-in gain or built-in loss among the partners in a manner that would substantially reduce the present value of the partners' aggregate tax liability.

LAW AND ANALYSIS

Ruling #1

P has requested a ruling that its method of aggregating gains and losses from qualified financial assets for the purpose of making reverse § 704(c) allocations is reasonable within the meaning of § 1.704-3(e)(3).

Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner is shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Section 1.704-3(a)(1) states that the purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under § 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of the contribution. This allocation must be made using a reasonable method that is consistent with the purpose of § 704(c).

Section 1.704-3(a)(6) provides that the principles of § 1.704-3 apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property under § 1.704-1(b)(2)(iv)(f) (reverse § 704(c) allocations). A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of §§ 704(b) and (c).

Section 1.704-3(a)(2) indicates that § 704(c) generally applies on a property-by-property basis. Therefore, in determining whether there is a disparity between adjusted tax basis and fair market value, the built-in gains and built-in losses on items of contributed or revalued property generally cannot be aggregated.

Section 1.704-3(e)(3) sets forth a special rule allowing certain securities partnerships to make reverse § 704(c) allocations on an aggregate basis. Specifically, § 1.704-3(e)(3)(i) provides that, for purposes of making reverse § 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purposes of § 704(c). Once a partnership adopts an aggregate approach, the partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership.

Section 1.704-3(e)(3)(iii)(A) defines a securities partnership as a partnership that is either a management company or an investment partnership, and that makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner who provides management services or investment advisory services to the partnership). Under § 1.704-3(e)(3)(iii)(B)(2), a partnership is an investment partnership if (1) on the date of each capital account restatement, the partnership holds qualified financial assets that constitute at least 90 percent of the fair market value of the partnership's non-cash assets, and (2) the partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under this § 1.704-3(e)(3) to make revaluations at least annually.

Section 1.704-3(e)(3)(ii) defines qualified financial assets as any personal property (including stock) that is actively traded, as defined in § 1.1092(d)-1 (defining actively traded property for purposes of the straddle rules).

Section 1.704-3(e)(3)(iv) and (e)(3)(v) describe two approaches to making aggregate reverse § 704(c) allocations that are generally reasonable -- the partial netting approach and the full netting approach. However, § 1.704-3(e)(3)(i) provides that other approaches may be reasonable in appropriate circumstances.

Section 1.704-3(a)(10) provides that an allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse § 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequence of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

Furthermore, § 1.704-3(e)(3)(vi) provides that the character and other tax attributes of gain or loss allocated to the partners under an aggregate approach must (1) preserve the tax attributes of each item of gain or loss realized by the partnership, (2) be determined under an approach that is consistently applied, and (3) not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability. It is represented that P's allocations will comply with § 1.704-3(e)(3)(vi).

P has elected to use the partial netting method for making reverse § 704(c) allocations as described in § 1.704-3(e)(3)(iv). Section 1.704-3(e)(3)(iv) provides that to use the partial netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the partial netting approach, on the date of each capital account restatement, the partnership: (A) nets its book gains and losses from qualified financial assets since the last capital account restatement and allocates the net among its partners; (B) separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and, (C) separately allocates the disparity between book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

After applying the relevant law to the information and representations submitted, we rule that P's method of making reverse § 704(c) allocations is a reasonable method within the meaning of § 1.704-3(e)(3), provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partnership in a manner that substantially reduces the present value of the partners' aggregate tax liability.

Ruling # 2

P also has requested permission to aggregate built-in gains and losses from qualified financial assets contributed to the P by a partner with built-in gains and built-in losses from revaluations of qualified financial assets held by the P for purposes of making allocations under §§ 704(c)(1)(A) and 1.704-3(a)(6).

The aggregation rule of § 1.704-3(e)(3) applies only to reverse § 704(c) allocations. Therefore, a securities partnership using an aggregate approach must generally account for any built-in gain or loss from contributed property separately. The preamble to § 1.704-3(e)(3) explains that the final regulations do not authorize aggregation of built-in gains and losses from contributed property with built-in gains and losses from revaluations because this type of aggregation can lead to substantial distortions in the character and timing of income and loss recognized by contributing partners. T.D. 8585, 1995-1 C.B. 120, 123. However, the preamble also recognizes that there may be instances in which the likelihood of character and timing distortions is

minimal and the burden of making § 704(c) allocations separate from reverse § 704(c) allocations is great. Consequently, § 1.704- 3(e)(4)(iii) authorizes the Commissioner to permit, by published guidance or letter ruling, aggregation of qualified financial assets for purposes of making § 704(c) allocations in the same manner as that described in § 1.704-3(e)(3).

In Rev. Proc. 2001-36, 2001-36 I.R.B. 1, the Service granted automatic permission for certain securities partnerships to aggregate contributed property for purposes of making § 704(c) allocations. Rev. Proc. 2001-36 also described the information that must be included with the ruling requests for permission to aggregate contributed property for purposes of making § 704(c) allocations submitted by partnerships that do not qualify for automatic permission.

In this case, P represents that the burden to P of making § 704(c) allocations separate from reverse § 704(c) allocations is substantial. P will use the partial netting approach described in § 1.704-3(e)(3)(iv) for making forward and reverse § 704(c) allocations. The likelihood that P and its partners could abuse this type of aggregation is minimal.

After applying the relevant law to the information submitted and representations made, we rule that P's method of making § 704(c) allocations, including reverse allocations, for its partners is a reasonable method within the meaning of §1.704-3(a)(1), and is permitted by the Commissioner under § 1.704-3(e)(4)(iii), provided that a contribution or revaluation of the property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

Except as specifically ruled upon above, we express no opinion on the federal tax consequences of the transactions described above under any other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, any transaction(s) that are not specifically covered by the above rulings.

This ruling is limited to allocations of gain or loss from the sale or other disposition of qualified financial assets made under § 704(b), § 704(c)(1)(A), and § 1.704-3(a)(6). Specifically, no opinion is expressed concerning allocations of items other than items of gain or loss from the sale or other disposition of qualified financial assets, or the aggregation of built-in gains and losses from qualified financial assets contributed to P by any partner other than the partners described in this ruling. P must maintain sufficient records to enable it and its partners to comply with §§ 704(c)(1)(b) and 737.

Additionally, this ruling applies only to the contributions to P by the partners for which the P supplied specific information concerning the contributed assets as described above, and not to any other contributions by the partners or any other future partner.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/s/ David R. Haglund

David R. Haglund
Senior Technician Reviewer
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
copy of this letter
copy for § 6110 purpose s