Internal Revenue Service

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Department of the Treasury

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Legend:

LLC =

X =

A =

B =

C =

D =

P1 =

P2 =

P3 =

P4 =

P5 =

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This responds to a submission dated July 26, 2001, together with subsequent correspondence, submitted on behalf of P1, requesting certain rulings under §§ 704, 721, and 7704 of the Internal Revenue Code.

FACTS

X is a publically traded corporation. As of D1, A and A's family (the "Family") owned or controlled n2% percent of the outstanding publically traded common stock of X. The Family owned n4 shares of unrestricted common stock of X that was held in n3 lots. On D1, X's common stock had a fair market value of $n3 per share. The Family's adjusted basis for the common stock ranged from $n1 to $n2 per share. Prior to the transactions described below, the n4 shares of unrestricted common stock owned by the Family were held by partnerships, P2 through P6 (the "Partnerships"), and trusts, TR1 through TR31 (the "Trusts").

On D2, the following occurred (1) Family members, A, B, C, and D contributed cash to form LLC, a Delaware limited liability company that is treated as a partnership for federal tax purposes, (2) TR1 through TR9 contributed their common stock in X to P3, P4, and P5, (3) the Partnerships, the remaining Trusts, and LLC funded P1. The Partnerships and Trusts contributed their common stock in X to P1 in exchange for limited partnership interests. The aggregate built-in gain of the common stock contributed to P1 by its partners was $n4. No partner contributed common stock in X to P1 that had built-in loss. LLC contributed cash to P1 in exchange for the general partnership interest. The X common stock contributed by the Partnerships and the Trusts accounted for n3% of the total value of the transferred assets, while LLC's contribution of cash constituted n1% of the transferred value. P1 represents that all interest in P1 were issued in a transaction (or transactions) that was not required to be registered under the Securities Act of 1933, as amended ("1933 Act").

The Family chose to consolidate its holdings of the X common stock in P1 to centralize Family control and management of the X common stock. P1 may sell the X common stock during the next n1 to n2 years. To comply with SEC rules, the sock is likely to be sold in numerous transactions over several years. Each Family member is subject to federal income tax at the highest applicable tax rate. Additionally, each Family member expects to continue to be subject to federal income tax at the highest applicable tax rate.

Except as required by § 704(c) and § 1.704-1(b)(4), each partner will be allocated a pro rata share of partnership income, gain, loss, deduction and credit in accordance with the regulations under § 704(b). Each partner's initial capital account balance will be the amount of money and the fair market value of the property contributed to P1 by the partner. Under § 1.704-1(b)(2)(iv)(f), P1 will revalue the property on P1's books upon the occurrence of a revaluation event. Revaluation events include (1) a contribution of money or other property (other than a de minimis amount) to P1 by a new or existing partner as consideration for an interest in P1, (2) the liquidation of P1 or a distribution of money or other property (other than a de minimis amount) by P1 to a retiring or continuing partner as consideration for an interest in P1, and (3) the end of each quarter in accordance with generally accepted industry accounting practices. Interests in P1 will not be traded on an established securities market. All operational and major decisions for P1 are made by LLC.

P1 has made the following additional representations:

(1) P1 qualifies as a securities partnership under § 1.704-3(e)(3)(iii).

(2) The number of partners in P1 will be limited to 100 or fewer calculated pursuant to § 1.7704-1(h).

(3) The stock of X is actively traded within the meaning of § 1.1092(d)-1.

LAW AND ANALYSIS

Ruling #1

P1 has requested a ruling that P1 will not be a "publically traded partnership" within the meaning of § 7704(b).

Section 7704(a) provides that a publicly traded partnership is treated as a corporation. Section 7704(b) and § 1.7704-1(a) provide that, for purposes of § 7704, the term "publicly traded partnership" means any partnership if interests in the partnership are (1) traded on an established securities market, or (2) readily tradable on a secondary market or the substantial equivalent thereof.

Section 1.7704-1(c) provides that interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable economically to trading on an established securities market.

Section 1.7704-1(h)(1) provides that interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof for purposes of § 7704(b) if (1) all interests in the partnership were issued in a transaction (or transactions) that was not required to be registered under the 1933 Act, and (2) the partnership does not have more than 100 partners at any time during the taxable year.

Section 1.7704-1(h)(3) provides that, for purposes of § 1.7704-1(h)(1), a person owning an interest in a partnership, grantor trust, or S corporation (flow-through entity), that owns, directly or through other flow-through entities, an interest in the partnership, is treated as a partner in the partnership only if (1) substantially all of the value of the beneficial owner's interest in the flow-through entity is attributable to the flow-through entity's interest (direct or indirect) in the partnership, and (2) a principal purpose of the use of the tiered arrangement is to permit the partnership to satisfy the 100-partner limitation of § 1.7704-1(h)(1)(ii).

It is represented that the number of partners of P1 is limited to 100 or fewer calculated pursuant to § 1.7704-1(h). No interest P1 has been issued in a transaction (or transactions) required to be registered under the 1933 Act. Accordingly, P1 is not a "publicly traded partnership" within the meaning of § 7704(b).

Ruling #2

P1 has requested a ruling that the transfer of property to P1 by its partners is not a transfer to an investment company within the meaning of § 351 and 1.351-1(c) if P1 were incorporated.

Section 721(a) provides that neither a partner nor a partnership will recognize gain or loss on a contribution of assets to a partnership in exchange for a partnership interest. Section 721(b) provides that subsection (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 351 states that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. Section 351 does not apply to a transfer of property to an investment company. Section 351(e)(1).

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"), 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.

According to section 1.351-1(c)(5) of the regulations, a transfer ordinarily results in diversification if two or more persons transfer nonidentical assets to a corporation in the exchange. For this purpose, transfers of nonidentical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, are disregarded in determining whether diversification has occurred.

In Rev. Rul. 87-9, 1987-1 C.B. 133, the Service held that a transfer to a corporation of shares of a corporation's stock by one transferor, coupled with a transfer of cash by another transferor would be treated as a transfer of nonidentical assets under section 1.351-1(c). Thus, it must be determined whether the transfer of the cash by LLC constituted an insignificant portion of the total value of assets transferred and should thus be disregarded in determining whether diversification has occurred.

In example (1) of section 1.351-1(c)(6) of the regulations, two individuals each transfer $10,000 of publicly-traded X corporation stock to Z, a newly organized corporation, for 50 shares of Z stock, and a third individual transfers $200 in Y corporation marketable securities to Z for one share of Z stock. The example holds that the third transferor's contribution, which amounts to slightly less than one percent of the total assets contributed, is ignored, and no diversification occurs.

Therefore, the contribution of cash by LLC is disregarded in determining whether diversification has occurred. As all of the other property transferred to P1 consists of the common stock of X, such transfer will not be considered a transfer to an investment company within the meaning of § 1.351-1(c)(1).

Ruling #3

P1 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)(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 P1’s allocations will comply with § 1.704-3(e)(3)(vi).

P1 has elected the aggregate method for making reverse § 704(c) allocations described in § 1.704-3(e)(3)(iv).

After applying the relevant law to the information and representations submitted, we rule that P1’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 partner’s aggregate tax liability.

Ruling # 4

P1 also has requested permission to aggregate built-in gains from qualified financial assets contributed to the P1 by a partner with built-in gains and built-in losses from revaluations of qualified financial assets held by the P1 for purposes of making allocations under § 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, the burden to P1 of making § 704(c) allocations separate from reverse § 704(c) allocations is represented to be substantial. P1 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 this type of aggregation could be abused by P1 and its partners is minimal. Every non-cash partner is contributing to P1 stock of X that has built-in gain. No partner is contributing to P1 qualified financial assets that have built-in loss. Because there is no netting of built-in gains and built-in losses on contribution, each partner's allocations of gain over time should be the same under the aggregate method as they would be if the built-in gains were tracked asset by asset-by asset and certificate-by-certificate. Moreover, P1 alternatively could have, through carefully planning which shares of X stock to sell at a particular time, achieved substantially identical allocations of gain as will be allocated to each partner under the aggregate approach.

After applying the relevant law to the information submitted and representations made, we rule that P1'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 P1 by any partner other than the partners described in this ruling. P1 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 P1 by the partners for which the P1 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,
David R. Haglund
Senior Technician Reviewer
Associate Chief Counsel
(Passthroughs and Special Industries)

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