Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:
September 20, 2000

Legend

Partnership =

Fund A =

Fund B =

Manager =

GP =

State =

Country =

Date 1 =
Date 2 =
Date 3 =

a =
b =
c =
d =
e =
f =
g =
h =
i =
j =
k =
l =

This responds to your representative's letter dated October 27, 1999, and subsequent correspondence, written on behalf of Partnership, requesting rulings under § 704(c) of the Internal Revenue Code.

Facts

On Date 1, Fund A was organized under the laws of Country as an exempt company. As an exempt company, Fund A represents that it is an unincorporated company exempt from tax under Country's law and that it will be treated as a corporation for United States federal income tax purposes. Fund A has a stockholders. There are no domestic persons owning, directly or indirectly, interests in Fund A. Fund A invests in a diversified portfolio primarily consisting of fixed income securities. As of Date 3, the fair market value of Fund A's securities was b; Fund A's gross unrealized built-in gain in those securities was c; and Fund A's gross unrealized built-in loss was d.

On Date 2, Fund B was organized as a State limited liability company. Fund B represents that it is classified as a partnership for federal tax purposes under §§ 301.7701-2 and 301.7701-3 of the Administration and Procedure Regulations. Fund B has e partners that include domestic individuals, partnerships, corporations, and trusts. All of the members in Fund B contributed solely cash in exchange for their interests in Fund B. Like Fund A, Fund B invests in a diversified portfolio primarily consisting of fixed income securities. As of Date 3, the fair market value of Fund B's securities was f; Fund B's gross unrealized built-in gain in those securities was g; and Fund B's gross unrealized built-in loss in those securities was h.

To reduce the costs of administering their investments, Fund A and Fund B plan to contribute all of their securities to Partnership, a newly formed limited partnership registered under Country's laws. Partnership represents that it will be classified as a partnership for federal tax purposes under §§ 301.7701-2 and 301.7701-3. Fund A and Fund B will contribute i and j lots of securities, respectively, to Partnership.

Partnership's investment objective is to achieve a superior level of return by investing in an actively managed, diversified portfolio consisting primarily of fixed income securities and by using a variety of instruments and techniques to reduce the interest rate sensitivity of the investments. Partnership will enter into an investment advisory agreement with Manager, pursuant to which Manager will provide investment advisory services to Partnership. GP, a Country special purpose corporation owned by Manager, will serve as the general partner of Partnership. In exchange for its services, GP will receive a k percent profits interest in Partnership. Partnership's remaining book profits and losses will be allocated in proportion to the partners' relative book capital accounts.

Except as required by § 704(c) and § 1.704-1(b)(4) of the Income Tax Regulations, each partner will be allocated a proportionate share of partnership income, gain, loss, deduction, and credit in accordance with the regulations under section 704(b).

Partnership represents that Fund A's and Fund B's transfer of assets to Partnership will not be taxable under § 721(b). Partnership also represents that it will qualify as a "securities partnership" within the meaning of § 1.704-3(e)(3)(iii), and that Partnership's, contributions, revaluations, and the corresponding allocations of tax items are not made with a view toward 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. Partnership further represents that it will make revaluations at least annually in accordance with § 1.704-3-(e)(3)(iii)(B)(2)(ii) and that the burden of making § 704(c) allocations separate from reverse § 704(c) allocations is substantial. In addition, Partnership represents that Fund A and Fund B have historically engaged in a considerable amount of short-term trading and expect that Partnership will do so as well; less than l percent of the securities currently held by Fund A and Fund B have been held for more than one year.

Partnership requests rulings that its method of making reverse § 704(c) allocations is reasonable under § 1.704-3(e)(3), and that it may aggregate built-in gains and losses from qualified financial assets contributed to it by a partner with built-in gains and losses from revaluations of qualified financial assets held by it for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations.

LAW AND ANALYSIS

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 contribution. This allocation must be made using any 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 pursuant to § 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) provides 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 purpose 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)(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 personal property for purposes of the straddle rules).

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 that provides management services or investment advisory services to the partnership).

Sections 1.704-3(e)(3)(iv) and (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: (A) preserve the tax attributes of each item of gain or loss realized by the partnership; (B) be determined under an approach that is consistently applied; and (C) not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability. Partnership has represented that its allocations will comply with § 1.704-3(e)(3)(vi).

Partnership 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 aggregate tax gain and aggregate tax loss to the partners in a manner that reduces 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 Partnership'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.

Partnership also has requested permission to aggregate built-in gains and losses from qualified financial assets contributed to Partnership with built-in gains and losses from revaluations of qualified financial assets held by Partnership for the purpose of making § 704(c) and reverse § 704(c) allocations.

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).

Partnership has represented that the burden of making § 704(c) allocations separate from reverse § 704(c) allocations is substantial. The characteristics of the assets to be contributed to Partnership, the investment strategies of Partnership, and Partnership's high annual asset turnover reduce the likelihood of abuse of an aggregate approach.

After applying the relevant law to the facts presented and the representations made, we conclude that Partnership may aggregate built-in gains and losses from qualified financial assets contributed to Partnership by Fund A and Fund B with built-in gains and losses from revaluations of qualified financial assets held by Partnership for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations, 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 partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

Except as specifically ruled upon above, no opinion is expressed 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, the transaction(s) that are not specifically covered by the above rulings. Specifically, no opinion is expressed concerning Partnership's classification as a partnership for federal tax purposes, the classification of Fund A, Fund B, or GP for federal tax purposes, or the tax consequences of any partner's contribution of assets to Partnership. 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). Moreover, this ruling applies only to the contributions by Fund A and Fund B described in this letter.

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

Pursuant to a Power of Attorney on file with this office, a copy of this letter is being sent to Partnership's two listed authorized representatives.

Sincerely,

/s/David R. Haglund
David R. Haglund
Senior Technician Reviewer, Branch 1
Associate Chief Counsel
(Passthroughs & Special Industries)

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