Internal Revenue Service

Number: **200633019**
Release Date: 8/18/2006
Index Number: 731.00-00, 7701.00-00,
704.01-04

Department of the Treasury
Washington, DC 20224

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Date:
April 19, 2006

Legend

Trust =

X =

Y =

State =

Date 1 =

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Dear

This responds to a letter dated August 31, 2005, and subsequent correspondence, submitted on behalf of Trust by Trust's authorized representative, requesting rulings under §§ 704, 731, and 7701 of the Internal Revenue Code.

The information submitted states that Trust was created on Date 1. Trust currently holds a diversified portfolio of securities including, without limitation, (i) a voting shares of X, (ii) b publicly traded, limited voting shares of X, (iii) marketable securities

and other investments with an aggregate fair market value of more than $c and (iv) cash and cash equivalents. Substantially all of the marketable securities (excluding X stock, and cash maintained in accounts for current trust administration expenses and income distributions) are held in numerous, separate investment accounts, with each investment account being managed by a professional investment manager, subject to defined investment objectives and guidelines for each investment account.

Trust will terminate after the death of every member of a specified group of individual beneficiaries. Prior to Trust's termination, the trustees of Trust propose to transfer Trust's marketable securities (perhaps including the limited voting X stock) to Y, a State limited liability company that was formed by Trust. Y has not yet been funded, and is wholly-owned by Trust; once funded, it will be managed solely by the trustees of Trust prior to Trust's termination. Trust represents that Y will not elect to be treated as an association taxable as a corporation, and therefore, Y will be treated as a disregarded entity for federal income tax purposes.

Upon the termination of Trust, the trustees of Trust propose to distribute membership interests in Y to the remainder beneficiaries (in accordance with the fractional share of Trust residue to which each remainder beneficiary, respectively, is entitled) rather than the actual individual securities. Trust states that the distribution of Y interests by Trust should be treated as (i) a non-taxable pro rata distribution of Y assets (subject to any related liabilities) to the remainder beneficiaries (in accordance with the fractional share of Trust residue to which each remainder beneficiary, respectively, is entitled), as if such assets had been distributed outright from Trust to the remainder beneficiaries; followed by (ii) a deemed capital contribution of those same assets by the remainder beneficiaries to Y in a non-taxable exchange for interests in Y. After the distribution of interests in Y to the remainder beneficiaries, Y will be converted to a partnership for federal tax purposes.

Trust represents that Y's operating 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 Y, liquidating distributions will 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), 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).

Additionally, the agreement provides that the capital accounts of the partners will be increased or decreased to reflect a revaluation of the property of Y on Y'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 Y by a new

or existing partner as consideration for an interest in Y; (b) The liquidation of Y or a distribution of money or other property (other than a de minimis amount) by Y to a retiring or continuing partner as consideration for an interest in Y; and (c) The end of each quarter in accordance with generally accepted industry accounting practices. Y will make revaluations at least annually in accordance with § 1.704-3(e)(3)(iii)(B)(2)(ii). Trust expects that Y will 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, Trust expects Y will have significant turnover in the composition of its portfolio.

The following are representations by Trust regarding Y. When Y converts to a partnership, Trust represents that Y will qualify as a "securities partnership" as defined in § 1.704-3(e)(3)(iii). The deemed contribution of the diversified portfolio of securities to Y by the beneficiaries of Trust will not be taxable under § 721(b) because this deemed contribution will not result, directly or indirectly, in a diversification of the interests of the respective remainder beneficiaries. Diversification will not occur because each remainder beneficiary will be deemed to receive and then immediately recontribute to Y a pro rata share of each and every asset held in Y immediately before distribution. The securities contributed to Y will be actively traded within the meaning of § 1.1092(d)-1. For purposes of making reverse § 704(c) allocations, Y 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). Y will consistently apply the partial netting approach to all of its qualified financial assets for all taxable years in which Y qualifies as a securities partnership. The partial netting approach adopted by Y will preserve the tax attributes of each item of gain or loss realized by Y. Each person that will own an interest, directly or indirectly, in Y 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, Trust represents that contributions or revaluations of property and the corresponding allocations of tax items by Y 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.

Trust requests the following rulings:

(1) Prior to the distribution of interests in Y to the remainder beneficiaries, Y will be a disregarded entity as long as it remains a single member limited liability company (wholly-owned by Trust) and items of income, deduction, credit, gains and losses with respect to assets held within Y should be reported directly on Trust's federal income tax returns (as if Trust continued to hold Y assets directly).

(2) Upon the final distribution of interests in Y to the remainder beneficiaries, Y will be converted from a disregarded entity to a partnership for federal tax purposes, and distribution of Y interests by the Trust shall be treated as (i) a non-taxable pro rata distribution of Y assets (subject to any related liabilities) to the remainder beneficiaries (in accordance with the fractional share of Trust residue to which each remainder beneficiary, respectively, is entitled), as if such assets had been distributed outright from Trust to the remainder beneficiaries; followed by (ii) a deemed capital contribution of those same assets by the remainder beneficiaries to Y in a non-taxable exchange for interests in Y.

(3) Y's use of the partial netting approach as defined in § 1.704-3(e)(3)(iv) for 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).

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

(5) After termination of Trust and distribution of Y interests, in-kind distributions of qualified financial assets from Y to one or more of its members should not be deemed a distribution of money under § 731(c). As a result, an in-kind distribution should not be treated as a "sale or exchange" and the distributee member should not recognize any gain or loss in connection therewith. Further, both (i) the "aggregate built-in gain or loss" at the partnership level, and (ii) the portion of such "aggregate built-in gain or loss" allocable to the partner receiving such distribution, may be adjusted by the full amount of net unrealized gain or loss in the assets so distributed.

Ruling Request #1

Section 301.7701-3(a) of the Procedure and Administration Regulations provides, in part, that a business entity that is not classified as a corporation under §§ 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an "eligible entity") can elect its classification for federal tax purposes. An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1)(ii) provides that in the absence of an election to be classified as an association, a domestic eligible entity with a single member will be disregarded as an entity separate from its owner if it has a single owner.

Trust's contribution of marketable securities to Y in exchange for the all of the ownership interests in Y will be disregarded for federal tax purposes because Y will not

elect to be classified as an association, and therefore, will be disregarded as an entity separate from Trust for federal tax purposes. Therefore, as long as Trust remains the single member of Y, items of income, deduction, credit, gains and losses with respect to assets held within Y should be reported directly on Trust's federal income tax returns as if Trust continued to hold Y assets directly.

Ruling Request # 2

Rev. Rul. 99-5, 1991-1 C.B. 434, explains the federal income tax consequences when a single member domestic limited liability company that is disregarded for federal tax purposes as an entity separate from its owner under § 301.7701-3 becomes an entity with more than one owner that is classified as a partnership for federal tax purposes.

Rev. Rul. 99-5 addresses two situations in which the disregarded entity becomes an entity classified as a partnership for federal tax purposes. In Situation 1, an unrelated person purchases an interest in the disregarded entity from its owner for cash. In Situation 2, an unrelated person contributes cash to the disregarded entity in exchange for an interest in the entity.

In Situation 1, Rev. Rul. 99-5 concludes that the purchase of an interest in a disregarded entity will be treated as the purchase of a share of the assets of the entity, the assets being treated as owned directly by the owner of the disregarded entity, followed immediately by the contribution of the assets by the purchaser and the original owner to a newly formed partnership in exchange for ownership interests.

In Situation 2, Rev. Rul. 99-5 concludes that the unrelated third party and the owner of the disregarded entity are treated as contributing cash and the entity's assets, respectively, to a newly formed partnership in exchange for partnership interests.

Upon Trust's terminating distribution of interests in Y to the remainder beneficiaries, Y will be converted from a disregarded entity to a partnership, similar to Situation 1, in Rev. Rul. 99-5. The distribution of Y interests by the Trust shall be treated as a non-taxable pro rata distribution of Y assets (subject to any related liabilities) to the remainder beneficiaries (in accordance with the fractional share of Trust residue to which each remainder beneficiary, respectively, is entitled), as if such assets had been distributed outright from Trust to the remainder beneficiaries. The beneficiaries will be treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership. Under § 721(a), no gain or loss will be recognized by the remainder beneficiaries as a result of the conversion of the disregarded entity to a partnership. Rev. Rul. 99-5, Situation 1.

Ruling Request # 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) provides 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 § 704(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) provides 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) provides that a securities partnership is 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 § 1.704-3(e)(3) to make revaluations at least annually.

Section 1.704-3(e)(3)(ii) provides that qualified financial assets are 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 § 1.704-3(e)(3)(v) provide 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. Trust represents that Y's allocations will comply with § 1.704-3(e)(3)(vi).

Trust represents that Y will elect the partial netting approach described in § 1.704-3(e)(3)(iv) for making reverse § 704(c) allocations. 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 amount to its partners; (B) separately aggregates all realized tax gains and all realized 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 the 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 if Y elects the partial netting approach for making reverse § 704(c) allocations, this will be a reasonable approach 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 partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

Ruling Request # 4

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 pre-contribution built-in gains and losses 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 private 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, 2001-1 C.B. 1326, 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.

Trust represents that the burden to Y of making § 704(c) allocations separate from reverse § 704(c) allocations will be substantial. Y will use the partial netting approach described in § 1.704-3(e)(3)(iv) for making § 704(c) and reverse § 704(c) allocations. The likelihood that this type of aggregation could be abused by Y and its partners is minimal.

After applying the relevant law to the information submitted and representations made, we rule that if Y uses the partial netting approach to make § 704(c) allocations, including reverse § 704(c) allocations, this will be 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.

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 Y by any partner other than the partners described in this ruling (the remainder beneficiaries). Y 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 Y (made in connection with the terminating distributions by Trust and treated as described above in ruling request # 2) by the partners for which Trust supplied specific information concerning the contributed assets as described above, and not to any other contributions by the partners or any other future partner.

Ruling Request # 5

Section 731(a) provides that in the case of a distribution by a partnership to a partner, (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution; and (2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in § 731(a)(2)(A) or § 731(a)(2)(B) is distributed to such partner, loss will be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of -- (A) any money distributed, and (B) the basis to the distributee, as determined under § 732, of any unrealized receivables (as defined in § 751(c)) and inventory (as defined in § 751(d)).

Section 731(c)(1) provides that for purposes of §§ 731(a)(1) and 737, the term "money" includes marketable securities, and such securities shall be taken into account at their fair market value as of the date of the distribution.

Section 731(c)(2)(A) provides that for purposes of § 731(c) the term "marketable securities" means financial instruments and foreign currencies which are, as of the date of the distribution, actively traded (within the meaning of § 1092(d)(1)).

Section 731(c)(2)(B)(iii) provides that for purposes of § 731(c) the term "marketable securities" also includes any financial instrument the value of which is determined substantially by reference to marketable securities.

Section 731(c)(2)(C) provides that the term "financial instrument" includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives.

Section 731(c)(3)(A)(iii) provides that § 731(c)(1) shall not apply to the distribution from a partnership of a marketable security to a partner if such partnership is an investment partnership and such partner is an eligible partner thereof.

Section 731(c)(3)(C)(i) provides that the term "investment partnership" means any partnership which has never been engaged in a trade or business and substantially all of the assets (by value) of which have always consisted of- "(I) money, (II) stock in a corporation, (III) notes, bonds, debentures, or other evidences of indebtedness, (IV) interest rate, currency, or equity notional principal contracts, (V) foreign currencies, (VI) interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described in any other subclause of this clause or in any commodity traded on or subject to the rules of a board of trade or commodity exchange, (VII) other assets specified in regulations prescribed by the Secretary, or (VIII) any combination of the foregoing."

Section 731(c)(3)(C)(ii) provides that a partnership shall not be treated as engaged in a trade or business by reason of (I) any activity undertaken as an investor, trader, or dealer in any asset described in § 731(c)(3)(C)(i), or (II) any other activity specified in regulations prescribed by the Secretary.

Section 731(c)(3)(C)(iii) provides that the term "eligible partner" means any partner who, before the date of the distribution, did not contribute to the partnership any property other than assets described in § 731(c)(3)(C)(i).

Based solely on the information provided and representations made, we conclude that the beneficiaries will be "eligible partners" of Y within the meaning of § 731(c)(3)(C)(iii), even though their asset contributions will be deemed contributions (as set out in ruling number 2), provided that the beneficiaries do not contribute any property other than property described in § 731(c)(3)(C)(i) prior to the date they receive an in-kind distribution from Y. If the condition stated above is met, and if Y meets the definition of an investment partnership under § 731(c)(3)(C)(i) after Y is converted from a disregarded entity to a partnership, an in-kind distribution to a partner of Y will not be treated as a distribution of money. As a result, the in-kind distributions will not cause the partner to recognize gain or loss under § 731(a). Further, both (i) the "aggregate built-in gain or loss" at the partnership level, and (ii) the portion of such "aggregate built-in gain or loss" allocable to the partner receiving such distribution, may be adjusted by the full amount of net unrealized gain or loss in the assets so distributed.

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 that is not specifically covered by the above rulings.

This ruling is directed only to the taxpayer who requested 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 forwarded to X's authorized representative and X's second authorized representative.

Sincerely,

J. Thomas Hines
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

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

cc: