Internal Revenue Service

Number: **201710007**
Release Date: 3/10/2017

Index Number: 704.01-04, 721.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

,

ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B01
PLR-121239-16

Date:
November 18, 2016

LEGEND

Surviving Partnership =

Terminating Partnership A =

Terminating Partnership B =

Terminating Partnership C =

Terminating Partnership D =

State =

Dear :

This responds to a letter dated June 30, 2016, and subsequent correspondence, requesting rulings under §§ 704 and 721 of the Internal Revenue Code.

The information submitted states that Surviving Partnership, Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D are State general partnerships treated as partnerships for federal tax purposes. Each partnership currently holds a diversified portfolio of stock and securities and an insignificant amount of cash, and the partnerships are owned by identical or related parties in substantially similar proportions. To reduce the costs and burdens associated with the administration of the separate partnerships, the partnerships plan to merge.

The partnerships represent that, under the merger rules of § 1.708-1(c) of the Income Tax Regulations, the resulting partnership will be deemed to be a continuation of Surviving Partnership, and Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D will be considered terminated. The merger will take the assets-over form as described in § 1.708-1(c)(3). Therefore, Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D will contribute all of their assets and liabilities to Surviving Partnership in exchange for interests in Surviving Partnership, and immediately thereafter, Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D will distribute their interests in Surviving Partnership to their partners in liquidation.

The partnerships represent that, immediately prior to the transfers, Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D, and Surviving Partnership will own a diversified portfolio of assets. In the merger Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D will contribute only a diversified portfolio of stock and securities and an insignificant amount of cash to Surviving Partnership. Immediately after the transfers, Surviving Partnership will own a diversified portfolio of assets. In each case, the test for diversification will apply the tests of § 368(a)(2)(F)(ii), § 351(e), and the regulations thereunder (§ 1.351-1(c)). The contributions are not part of a plan to achieve diversification without recognition of gain as described in § 1.351-1(c)(5).

Surviving Partnership represents that after the merger it will qualify as a “securities partnership” as defined in § 1.704-3(e)(e)(iii). Each partnership currently uses, and Surviving Partnership will continue to use, the partial netting approach described in § 1.704-3(e)(3)(iv) for making reverse § 704(c) allocations. Surviving Partnership’s § 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). Surviving Partnership will consistently apply the partial netting approach to all of its qualified financial assets for all taxable years in which it qualifies as a securities partnership. Surviving Partnership represents that the partial netting approach it adopted will preserve the tax attributes of each item of gain or loss it realizes and will not be used with a view to reducing substantially the present value of the partners' aggregate tax liability. Contributions of property (or the event that results in reverse § 704(c) allocations) and the corresponding allocation of tax items with respect to the property will not be made with a view to shifting the tax consequences of built-in gain or loss among Surviving Partnership’s partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability. Surviving Partnership's operating agreement will comply with §§ 704(b) and 704(c). It will require that a separate capital account be established and maintained for each partner as required by the regulations under § 704(b). The agreement will provide for a mandatory deficit make-up upon the winding up of Surviving Partnership. The agreement will also require the maintenance of separate unrealized gain and loss accounts for each partner so as to comply with the partial netting approach in § 1.704-3(e)(3)(iv). Surviving Partnership will revalue its assets at least quarterly. Thus, Surviving Partnership will make revaluations at least annually in accordance with § 1.704-3(e)(3)(iii)(B)(*2*)(*ii*).

After the mergers, Surviving Partnership will continue to be managed by professional investment managers and subject to defined investment objectives and guidelines. The investment managers will actively manage Surviving Partnership's assets and make decisions about selling and buying securities based on their perception of opportunities. Thus, Surviving Partnership will continue to have significant turnover in the composition of its portfolio of assets. The burden to Surviving Partnership of making § 704(c) allocations separately from reverse § 704(c) allocations is substantial.

The partnerships request the following rulings:

(1) The contributions to Surviving Partnership by Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D pursuant to the merger will not be taxable under § 721(b).

(2) Surviving Partnership'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).

(3) Surviving Partnership has permission to aggregate built-in gains and losses from qualified financial assets contributed by Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, or Terminating Partnership D with built-in gains and built-in losses from revaluations of qualified financial assets held by Surviving Partnership for purposes of making allocations under §§ 704(c)(1)(A) and 1.704-3(a)(6).

Ruling Request #1

Section 721(a) provides that no gain or loss is 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.

Section 721(b) provides that § 721(a) shall not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of § 351) if the partnership were incorporated.

Section 351(a) provides that no gain or loss is recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and immediately after the exchange the transferors control the transferee corporation. Section 351(e)(1) provides that § 351(a) will not apply to a transfer of property to an “investment company.”

Section 1.351-1(c)(1) of the Income Tax Regulations states that a transfer to an investment company will occur when (i) the transfer results in diversification of the transferors' interests, and (ii) the transferee is a regulated investment company (RIC), a regulated investment trust (REIT), or a corporation more than 80 percent 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.

Section 1.351-1(c)(6)(i) provides that a transfer of stocks and securities will not be treated as resulting in diversification if each transferor transfers a diversified portfolio of stocks and securities. A portfolio of stock and securities is diversified if it satisfies the 25 and 50-percent tests of § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F). For this purpose, government securities are included in determining total assets, unless the government securities are acquired to meet § 368(a)(2)(F)(ii).

After applying the law to the facts submitted and representations made, we conclude that Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D’s transfers of all their assets to Surviving Partnership pursuant to the merger will not result in a diversification of the portfolios transferred. Accordingly, no gain will be recognized under § 721 on Terminating Partnership A’s, Terminating Partnership B’s, Terminating Partnership C’s, and Terminating Partnership D’s transfers of diversified portfolios of assets to Surviving Partnership pursuant to the mergers of Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D into Surviving Partnership.

Ruling Request # 2

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 a qualified financial asset is 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. Surviving Partnership represents that its allocations will comply with § 1.704-3(e)(3)(vi).

Surviving Partnership represents it has elected 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 Surviving Partnership's use of the partial netting approach for making reverse § 704(c) allocations is 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 # 3

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 IRS 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.

Surviving Partnership represents that the burden of making § 704(c) allocations separate from reverse § 704(c) allocations will be substantial. Surviving Partnership 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 Surviving Partnership and its partners is minimal.

After applying the relevant law to the information submitted and representations made, we rule that if Surviving Partnership 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 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 Surviving Partnership by any person other than Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D. Surviving Partnership 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 Surviving Partnership made in connection with the mergers of

Terminating Partnership A, Terminating Partnership B, Terminating Partnership C, and Terminating Partnership D into Surviving Partnership and not to any other contributions or any other future partner.

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. However, in the event of a technical termination of Surviving Partnership under § 708(b)(1)(B), the resulting partnership may continue to rely on this ruling with regard to any relevant ruling contained within. 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 your authorized representatives.

Sincerely,

David R. Haglund
David R. Haglund
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter
Copy of this letter for § 6110 purposes