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Date:
April 06, 1999

Legend:

X =

Y =

State =

This responds to your letter dated December 18, 1998, requesting certain rulings regarding the distribution of partnership interests held by a partnership, the subsequent contribution of those interests to a newly formed partnership, and the newly formed partnership's use of an aggregate method for making § 704(c) allocations.

FACTS

X is a limited partnership formed under the laws of State. Each of the persons who holds an interest in X contributed only cash to X, who, in turn, invested the cash in approximately 15 partnerships. X does not hold more than a 15 percent interest in the capital and profits of any of the partnerships. At least 90 percent of the assets of each of the 15 partnerships in which X is invested consist of marketable securities, money or both. X has never been engaged in a trade or business and at least 90 percent of X's assets (by value) have always consisted of its interests in the aforementioned partnerships.

To maintain the benefits of its current size and exemption from the Investment Company Act of 1940, the general partner of X and approximately 30 percent of X's limited partners intend to capitalize a newly formed limited partnership, Y, whose investments will primarily be in other partnerships. In this connection, X intends to make a pro-rata

distribution of the interests it holds in the partnerships to the limited partners in proportion to their respective positive capital account balances. Each of the limited partners of X participating in the plan has a positive capital account balance. After the distribution, the limited partners will immediately contribute the distributed partnership interests to Y.

X may also make a pro-rata non-liquidating distribution to the general partner of X of its pro-rata portion of the partnership interests. The general partner will then immediately contribute the distributed partnership interests to Y. Alternatively, the general partner may contribute cash to Y. In no case, however, will the fair market value of the general partner's contribution to Y exceed 1 percent of the fair market value of the assets of Y.

After its initial formation and capitalization, Y will admit additional partners in exchange for cash contributions. The cash contributions made by the additional partners will be contributed to the new partnerships held by Y, or other similar partnership investments that may be acquired by Y.

LAW AND ANALYSIS

Ruling 1

Section 731(a) of the Code provides that in the case of a distribution by a partnership to a partner (1) gain will 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 will 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 (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)(2)).

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

Section 731(c)(2)(A) of the Code provides, in general, that 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)(v) of the Code provides that, except as otherwise provided in regulations, the term "marketable securities" includes interests in an entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both. Section 731(c)(2)(B)(vi) provides that, to the extent provided in

regulations, such term includes any interest in an entity not described in § 731(c)(2)(B)(v) but only to the extent of the value of such interest which is attributable to marketable securities, money or both.

Section 1.731-2(c)(3)(i) of the regulations provides that, for purposes of § 731(c)(2)(B)(v) of the Code, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both. Section 1.731-2(c)(3)(ii) provides that, for purposes of § 731 (c)(2)(B)(vi), an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

Section 731(c)(3)(A)(iii) of the Code provides that § 731(c)(1) will 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) of the Code provides that, for purposes of § 731(c)(3)(A)(iii), 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) interest in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described in § 731(c)(3)(C)(i) 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, or (VIII) any combination of the foregoing.

Section 731(c)(3)(C)(iii)(I) of the Code 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 property described in § 731(c)(3)(C)(i).

Ruling 2

Section 721(a) of the Code provides that no gain or loss shall be recognized by either a partnership or its partners on the contribution of property to the partnership in exchange for an interest in the partnership. Section 721(b), however, provides that gain (but not loss) realized on such a transfer may be recognized if the partnership would be treated as an investment company within the meaning of § 351 of the Code, if the partnership were incorporated.

Section 1.351-1(c)(1) provides that a transfer to an investment company occurs

when (i) the transfer results, directly or indirectly, in diversification of the transferors' interests, and (ii) more than 80 percent of the value of the transferee's assets are stocks and securities that are held for investment. Section 351(e) provides that the term stocks and securities includes stock, indebtedness, money and other equity interests. Section 351(e)(1)(B)(vi) provides that an interest in an entity will be treated as a stock or security if substantially all of the assets of such entity consist of stocks and securities as defined in § 351(e).

Under § 1.351-1(c)(2), the determination of whether a corporation is an investment company shall ordinarily be made by reference to the circumstances in existence immediately after the transfer in question. However, where the circumstances change thereafter pursuant to a plan in existence at the time of the transfer, the determination shall be made by reference to the later circumstances.

Section 1.351-1(c)(5) provides that if there is only one transferor (or two or more transferors of identical assets) to a newly organized corporation, the transfer will generally be treated as not resulting in diversification. Further, if non-identical assets are transferred and they constitute an insignificant portion of the total value of assets transferred, such transfers are disregarded in determining whether diversification has occurred.

Ruling 3

Section 704(c)(1)(A) provides that under regulations prescribed by the Secretary income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be 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) of the regulations provides that the purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution 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. Notwithstanding any other provision of § 1.704-3, the allocations must be made using a reasonable method that is consistent with the purpose of § 704(c).

Section 1.704-3(a)(6) of the regulations 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).

Section 1.704-3(e)(3)(i) of the regulations 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).

Section 1.704-3(e)(4)(iii) provides that the Commissioner may permit, either by published guidance or by letter ruling, the aggregation of qualified financial assets for purposes of making section 704(c) allocations in the same manner as that described § 1.704-3(e)(3).

Section 1.704-3(e)(3)(iii)(A) of the regulations provides that a partnership is a securities partnership if the partnership is either a management company or an investment partnership, and the partnership 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).

Section 1.704-3(e)(3)(ii) provides that a qualified financial asset is any personal property (including stock) that is actively traded. Actively traded means actively traded as defined in § 1.1092(d)-1.

Section 1.704-3(e)(3)(ii)(C) provides that an interest in a partnership is not a qualified financial asset for purposes of § 1.704-3(e)(3)(ii). Further, if a partnership (upper-tier partnership) holds an interest in a securities partnership (lower-tier partnership) the upper-tier partnership must take into account the lower-tier partnership's assets and qualified financial assets as follows: (1) in determining whether the upper-tier partnership qualifies as an investment partnership, the upper-tier partnership must treat its proportionate share of the lower-tier securities partnership's assets as assets of the upper-tier partnership; and (2) if the upper-tier partnership adopts an aggregate approach, the upper-tier partnership must aggregate the gains and losses from its directly held qualified financial assets with its distributive share of the gains and losses from the qualified financial assets of the lower-tier securities partnership.

CONCLUSIONS

Accordingly, based solely on the facts presented and representations made in this ruling request, and viewed in light of the applicable law and regulations, we rule as follows:

Ruling 1

We conclude that each of X's interests in the 15 partnerships in which it is invested constitutes a "marketable security" as defined in § 731(c), X is an investment partnership,

and each limited partner and the general partner of X is an "eligible partner" within the meaning of § 731(c)(3)(C)(iii). Accordingly, the limited partners and the general partner of X will not recognize gain or loss on the distribution to them of their pro-rata share of the partnership interests that X holds.

Ruling 2

The contribution of the partnership interests to Y will not result in diversification of the interests of the limited partners or the general partner and will not be treated as a transfer described in § 721(b). Further, since any cash contributions by additional partners will constitute an insignificant portion of the total value of assets transferred, such transfers will be disregarded in determining whether diversification has occurred. Therefore, the transfer of the diversified assets by each limited partner and general partner to Y will not be a transfer to an investment company within the meaning of § 351(e)(1) and the contribution of the partnership interests to Y will be tax-free under § 721(a). Later cash contributions by additional partners to Y will not cause the limited partners or the general partner to recognize gain under § 721(b).

Ruling 3

Y is a securities partnership for purposes of § 1.704-3(e)(3) of the regulations. You have represented that each of the partnerships that Y will be invested in will also be a securities partnership. Accordingly, pursuant to § 1.704-3(e)(3), Y is permitted to make allocations on an aggregate basis, netting the pre-contribution gain or loss with respect to each partnership interest. Furthermore, we conclude that the approach used by Y to aggregate gains and losses from qualified financial assets is a reasonable approach that is consistent with the purposes of § 704(c).

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) of the Code provides that it may not be used or cited as precedent.

CC:DOM:P&SI:1-PLR-122771-98

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

Sincerely,

Signed/David R. Haglund

David R. Haglund
Senior Technician Reviewer, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

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