

Internal Revenue Service

Department of the Treasury

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Date:

December 1, 1998

Legend

LLC =

FundA =

FundB =

FundC =

D =

FundE =

FundF =

STATE =

a = -

r =

b =

s =

c =

t =

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<u>d</u>	=	<u>u</u>	=
<u>e</u>	=	<u>v</u>	=
<u>f</u>	=	<u>w</u>	=
<u>g</u>	=	<u>x</u>	=
<u>h</u>	=	<u>y</u>	=
<u>i</u>	=	<u>z</u>	=
<u>j</u>	=	<u>aa</u>	=
<u>k</u>	=	<u>bb</u>	=
<u>l</u>	=	<u>cc</u>	=
<u>m</u>	=	<u>dd</u>	=
<u>n</u>	=	<u>ee</u>	=
<u>o</u>	=	<u>ff</u>	=
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<u>q</u>	=	<u>hh</u>	=

This responds to your representatives' letter dated November 6, 1998, and prior correspondence, written on behalf of LLC, requesting rulings under § 704(c) of the Internal Revenue Code.

FACTS

FundA, FundB, FundC, and D plan to form LLC, a STATE limited liability company that will be treated as a partnership for federal tax purposes under §§ 301.7701-2 and 301.7701-3 of the Administration and Procedure Regulations. After LLC's formation, partners in FundE who invest in FundF, an investment fund maintained by FundE, will contribute their interests in FundF to LLC in exchange for member interests in LLC.

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FundA, FundB, and FundC are STATE general partnerships that invest in a portfolio of publicly traded stocks that mirrors the Standard & Poors 500 Composite Price Index. Accordingly, each of the three funds owns shares of all of the approximately 500 publicly traded stocks that comprise the S&P 500 Index. At any given time, the funds may also hold relatively small amounts of cash or short-term investments. Additionally, each may own S&P Index future contracts that it acquired to mirror more closely the S&P 500 Index.

D is a STATE not for profit corporation which is recognized by the Service as exempt from federal income tax under § 501(c)(3) and is a private foundation within the meaning of § 509(a). D's investments include a stock portfolio (FundD) whose economic performance is intended to match that of the Wilshire 5000 Composite Price Index. The Wilshire Index is composed of the publicly listed stock of approximately 6,200 companies. FundD owns stock in only the 1,700 largest companies included in the Wilshire Index to reduce management expenses while approximately matching the performance of the Wilshire Index. These stocks include the same company stocks as owned by FundA, FundB, and FundC, plus stock in approximately 1,200 additional companies. FundD may also hold relatively small amounts of cash or short-term investments and stock index future contracts.

FundE operates three separate investment funds. At their option, FundE's partners may invest in one, two, or all three of the funds. FundE segregates the assets of each fund, and the income, expenses, gain, and losses of each fund are shared only by the FundE partners investing in that fund. FundF is one of the three investment funds FundE operates.

FundE designed FundF to match the economic performance of the Wilshire Index. FundF's portfolio includes approximately 1,200 stocks. Additionally, FundF may also have small amounts of cash or short-term investments and stock index future contracts.

FundA, FundB, FundC, FundD, and FundF (the "Funds") generally have no liabilities, and all had none as of December 31, 1997. As of December 31, 1997, all of their assets and the value of those assets were as follows:

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	FundA	FundB	FundC	FundD	FundF
Stocks	\$ <u>a</u>	\$ <u>e</u>	\$ <u>h</u>	\$ <u>l</u>	\$ <u>p</u>
Cash & Equivalents	\$ <u>b</u>	\$ <u>f</u>	\$ <u>i</u>	\$ <u>m</u>	\$ <u>q</u>
Futures	\$ <u>c</u>	\$ <u>c</u>	\$ <u>c</u>	\$ <u>n</u>	\$ <u>c</u>
Start-up Costs	\$ <u>c</u>	\$ <u>c</u>	\$ <u>j</u>	\$ <u>c</u>	\$ <u>r</u>
-----	-----	-----	-----	-----	-----
Total Net Assets	\$ <u>d</u>	\$ <u>g</u>	\$ <u>k</u>	\$ <u>o</u>	\$ <u>s</u>

The total fair market value of the Funds' assets substantially exceeds the aggregate tax basis each fund has in its assets. At December 31, 1997, these amounts and the resulting built-in gain amounts were as follows:

	FundA	FundB	FundC	FundD	FundF
Market Value	\$ <u>t</u>	\$ <u>w</u>	\$ <u>z</u>	\$ <u>cc</u>	\$ <u>ff</u>
Tax Basis	\$ <u>u</u>	\$ <u>x</u>	\$ <u>aa</u>	\$ <u>dd</u>	\$ <u>gg</u>
-----	-----	-----	-----	-----	-----
Built-in Gain	\$ <u>v</u>	\$ <u>y</u>	\$ <u>bb</u>	\$ <u>ee</u>	\$ <u>hh</u>

Each of the Funds pays custodial and investment management fees. In addition, each of the Funds incurs substantial operating expenses. LLC represents that the purpose of its formation is to consolidate the portfolios of the partners that have identical investment objectives to reduce these fees and achieve economies of scale. LLC also represents that at the time it commences operations it will not own any asset in which it has a built-in loss. LLC may receive contributions of cash (but not property) from newly-admitted or current members.

FundA, FundB, and FundC represent that they each currently allocate their reverse § 704(c) gains and losses from qualified financial assets on an aggregate basis and that each is permitted to do so under the applicable regulations. FundA, FundB, and FundC also represent that, because all capital contributions to the funds have been made in cash, each fund has no § 704(c) property.

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LLC requests rulings 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 and that LLC's method of making § 704(c)(1)(A) allocations is reasonable under § 1.704-3(e)(3) of the Income Tax Regulations.

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 704(c) generally applies on a property-by-property basis. Section 1.704-3(a)(2). 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.

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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.

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) only applies to reverse § 704(c) allocations; thus, 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. *Id.* Consequently, § 1.704-3(e)(4)(iii) authorizes the Commissioner to permit, by published guidance or by 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 this case, LLC's burden of making § 704(c) allocations separate from reverse § 704(c) allocations is substantial. FundA, FundB, FundC, D, and FundF will contribute a large number of different assets to LLC. Unless the Commissioner permits LLC to aggregate § 704(c) gains and losses with reverse § 704(c) gains and losses, LLC will have to track most of the unrealized gains and losses from revaluations on a property-by-property basis. Tracking most of the unrealized gains and losses from revaluations on a property-by-property basis largely nullifies the benefits of the aggregate approach for making reverse § 704(c) allocations.

The tax characteristics of LLC's partners, the size of their interests in LLC, and the characteristics of the assets to be contributed to LLC reduce the likelihood of abuse of an aggregate approach. Accordingly, based on the facts presented and the representations made, we conclude that LLC may aggregate built-in gains and losses from qualified financial assets contributed to LLC by its partners with built-in gains and losses from revaluations of qualified financial assets held by LLC for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations. In addition, LLC's use of the full netting method of making § 704(c)(1)(A) allocations is reasonable within the meaning of § 1.704-3(e)(3).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the

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Code. Specifically, no opinion is expressed concerning LLC's classification as a partnership for federal tax purposes or on the tax consequences of any partner's contribution of assets to LLC.

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 LLC's authorized representative.

Sincerely,

signed/Daniel J. Coburn
DANIEL J. COBURN
Assistant to the Branch Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy of this letter for § 6110 purposes