

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability

(Also: Part I, Sections 704(c); 1.704-3(e)(3).)

Rev. Proc. 2007-59

SECTION 1. PURPOSE

The purpose of this revenue procedure is to permit certain partnerships to aggregate gains and losses from an expanded class of qualified financial assets for purposes of making reverse section 704(c) allocations under §1.704-3(e)(3).

SECTION 2. BACKGROUND

01. To prevent the shifting of tax consequences among partners with respect to precontribution gain or loss, section 704(c) requires partnerships to allocate income, gain, loss, and deductions with respect to property contributed by a partner 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. These allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). Section 1.704-3(a)(6) provides that similar rules apply to differences between book value and tax basis that are created by a revaluation of partnership assets pursuant to §1.704-1(b)(2)(iv)(f) (reverse section 704(c) allocations).

02. Section 1.704-3(a)(2) provides that section 704(c) allocations are generally made on a property-by-property basis. Therefore, built-in gains and losses from different items of contributed or revalued property generally cannot be aggregated.

03. Section 1.704-3(e)(3) provides a special rule that allows securities partnerships to make reverse section 704(c) allocations on an aggregate basis. Specifically, §1.704-3(e)(3)(i) provides that, for purposes of making reverse section 704(c) allocations, a securities partnership may aggregate built-in gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of section 704(c).

04. Section 1.704-3(e)(3)(iii)(A) 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).

05. Section 1.704-3(e)(3)(iii)(B)(1) provides that a partnership is a management company if it is registered with the Securities and Exchange Commission as a

management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).

06. Section 1.704-3(e)(3)(iii)(B)(2) provides that 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.

07. Section 1.704-3(e)(3)(ii)(A) 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 (defining actively traded property for purposes of the straddle rules). In addition, under §1.704-3(e)(3)(ii)(B), for management companies, qualified financial assets also include the following, even if not actively traded: shares of stock in a corporation; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

08. Sections 1.704-3(e)(3)(iv) and (v) describe two methods of making reverse section 704(c) allocations on an aggregate basis that are generally reasonable, the partial netting and the full netting approaches, respectively.

09. 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 section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are 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.

10. Section 1.704-3(e)(4) provides in relevant part that the Commissioner may, by published guidance or by letter ruling, permit: (1) aggregation of properties other than assets described in paragraphs (e)(2) and (e)(3) of §1.704-3; (2) partnerships other than securities partnerships to aggregate gain and loss from qualified financial assets; and (3) aggregation of qualified financial assets for purposes of making section 704(c) allocations in the same manner as that described in paragraph (e)(3) of §1.704-3.

SECTION 3. DEFINITIONS

01. *Qualified Partnerships.* For purposes of this revenue procedure, a partnership is a Qualified Partnership if it satisfies the following requirements: (1) 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); (2) the partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under this revenue procedure, to make revaluations of qualified financial assets at least four times annually; (3) on the date of each capital account restatement during the taxable year, the partnership holds qualified financial assets that constitute at least 90 percent of the partnership's non-

cash assets; (4) the partnership reasonably expects, as of the first day of each taxable year for which the partnership seeks to aggregate under this revenue procedure, that the partnership (a) will have at least 10 unrelated partners at all times during the taxable year; and (b) will make at least 200 trades of qualified financial assets during the taxable year, the aggregate value of which will comprise at least 50% of the book value of the partnership's assets (including cash) as of the first day of the taxable year; and (5) the application of the aggregation method to reverse section 704(c) allocations under this revenue procedure is 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. For purposes of this paragraph, partners are treated as related if they are related within the meaning of sections 267(b) or 707(b).

02. *Qualified financial assets.* Solely for purposes of this revenue procedure, qualified financial assets are (1) those assets described in §1.704-3(e)(3)(ii)(A) and (B); (2) any interest in a partnership that is traded on an established securities market or readily tradable on a secondary market or the substantial equivalent thereof within the meaning of §1.7704-1(c); and (3) any interest owned by the partnership (the upper-tier partnership) in a partnership (the lower-tier partnership) that represents it is a securities partnership or a Qualified Partnership, provided that such interest is (i) less than 10 percent of the capital and profits of the lower-tier partnership and that the upper-tier partnership does not actively or materially participate in the management or operations of the lower-tier partnership; and (ii) less than 5 percent of the total book value of the

upper-tier partnership's assets (including cash) as of the first day of the taxable year.

SECTION 4. APPLICATION

01. *Automatic permission to aggregate qualified financial assets.* Permission is hereby granted to any Qualified Partnership as defined in this revenue procedure to aggregate built-in gains and losses from qualified financial assets for purposes of making reverse section 704(c) allocations under §1.704-3(e)(3). Pursuant to §1.704-3(e)(3)(i), once a partnership adopts an aggregate approach under this revenue procedure, that 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 Qualified Partnership. However, a partnership may choose not to aggregate all of the partnership's qualified financial assets provided that such qualified assets do not exceed in the aggregate 30 percent of the book value of the partnership's non-cash assets at the time any such qualified financial assets is acquired.

02. *Subsequent failure to qualify as a Qualified Partnership.* A Qualified Partnership that adopts an aggregate approach under this revenue procedure and subsequently fails to qualify as a Qualified Partnership must make reverse section 704(c) allocations on an asset-by-asset basis after the date of disqualification. The partnership, however, is not required to disaggregate the book gain or book loss from qualified asset revaluations before the date of disqualification when making reverse section 704(c) allocations on or after the date of disqualification.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for taxable years beginning on or after

October 1, 2007. However, taxpayers may apply this revenue procedure to taxable years beginning after December 31, 2005.

SECTION 6. REQUEST FOR COMMENTS

.01 *Comments Requested.* The Treasury and the IRS request comments on the appropriateness of the factors used to define Qualified Partnerships and qualified financial assets. Additionally, comments are requested on whether additional factors should be considered in defining Qualified Partnerships and qualified financial assets. The Treasury and the IRS also request comments as to whether additional guidance regarding the aggregation of qualified financial assets for purposes of making reverse section 704(c) allocations is appropriate or necessary.

.02 *Submission of Comments.* Written comments may be submitted to the Office of Associate Chief Counsel (Passthroughs & Special Industries), Attention: Jonathan E. Cornwell (Revenue Procedure 2007-59), CC:PSI:B01, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to notice.comments@irs.counsel.treas.gov. Please include "Revenue Procedure 2007-59" in the subject line of any electronic communications. Comments will be available for public inspection and copying.

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue procedure are Jonathan E. Cornwell and Steven A. Schmoll of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue procedure, contact Mr. Cornwell or Mr. Schmoll at (202) 622-3050 (not a toll free call).