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Date:
April 14, 2005

Legend

Partnership =

State 1 =

Date 1 =

Date 2 =

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Dear :

This letter responds to your letter on behalf of Partnership dated August 23, 2004, requesting rulings under §§ 704(b) and 704(c) of the Internal Revenue Code.

FACTS

The facts as represented by Partnership are as follows:

Partnership was newly formed under State 1 law on Date 1 and operates under an agreement of limited partnership dated Date 2. Pursuant to a merger agreement dated as of Date 2, eight pre-existing partnerships (Consolidating Partnerships) were merged into Partnership under § 1.708-1(c)(3)(i) of the Income Tax Regulations. Prior to the merger, the Consolidating Partnerships held royalty interests (either directly or indirectly) in oil and gas properties, cash, and receivables. The partners of each Consolidating Partnership were allocated shares of the tax bases of each of the royalty interests proportionate to their respective capital contributions. As a result of the merger (i) the Consolidating Partnerships terminated; (ii) the Consolidating Partnerships contributed all of their assets and liabilities to Partnership in exchange for interests in Partnership; and (iii) the former partners of the Consolidating Partnerships received

percentage interests¹ in Partnership reflecting the relative values of the Consolidating Partnerships (excluding the cash and receivables) and of the interests of the former partners therein. The partnership agreement requires Partnership to distribute the cash and receivables (to the extent exceeding the accounts payable of each separate Consolidating Partnership and \$c reimbursed to the general partner for organizational and offering expenses) to the former partners of each Consolidating Partnership.

All of the oil and gas properties contributed in the merger are subject to depletion. Most of the oil and gas properties have fair market values in excess of their adjusted tax basis. The partnership agreement does not require additional capital contributions subsequent to the merger that would alter the partners' percentage interests in Partnership.

A separate capital account will be maintained by Partnership for each partner in accordance with the requirements of § 1.704-1(b)(2)(iv) of the regulations. Distributions in liquidation of Partnership will be made to the partners pro rata in accordance with their respective positive capital account balances. In the event any partner has a deficit capital account balance following liquidation of its interest in Partnership, such partner will have no obligation to make any contribution to the capital of Partnership, and such deficit will not be considered a debt owed by the partner to the partnership or any other person for any purpose whatsoever.

Partnership will adjust its capital accounts using simulated cost depletion. Under § 3.5(c) of the partnership agreement, simulated depletion with respect to each oil and gas property will be allocated to the capital accounts of the partners to whom a share of Partnership's tax basis in such oil or gas property has been allocated. Under § 3.5(d) and § 5.4(b)(i)(B), simulated gain realized upon the sale or other taxable disposition of any oil or gas property will be allocated to each partner so that the capital account balances of the partners become proportionate to their respective percentage interests. Any remaining simulated gain will be allocated in accordance with the partners' percentage interests in Partnership. Simulated loss will be allocated in proportion to the partners' allocable shares of the adjusted tax basis (or, if applicable book value) of the property.

Section 5.1 generally provides that the profits and losses for each fiscal year will be allocated to the capital accounts of the partners in accordance with their percentage interests. Any tax credits available to Partnership will be allocated to the capital accounts of the partners in accordance with their respective percentage interests.

¹ The term "percentage interests" means with respect to the general partner, the general partner percentage, and with respect to the limited partners, a limited partner's share of the unitholder percentage. The term "general partner percentage" means a%. The term "unitholder percentage" means b%.

Section 5.2 generally provides that (a) to the extent profits or losses from capital transactions for any fiscal year are properly accounted for, for purposes of the partners' capital accounts under § 1.704-1(b), through the allocation of simulated gain or simulated loss, such amounts will be allocated to the capital accounts of the partners as provided in § 3.5(d); and (b) to the extent, if any that profits or losses from capital transactions for any fiscal year are not subject to § 5.2(a), such amounts will be allocated to the capital accounts of the partners in accordance with their respective percentage interests.

Section 5.3(a) generally provides that, notwithstanding §§ 5.1 and 5.2, no losses, losses from capital transactions, items thereof, or other items in the nature of loss or other deduction shall be allocated to a partner to the extent that such allocation would cause such partner to have an adjusted capital account deficit. In the event any partner unexpectedly receives in any fiscal year any adjustments, allocations or distributions described in §§ 1.704-1(b)(2)(ii)(d)(4), 1.704-1(b)(2)(ii)(d)(5), or 1.704-1(b)(2)(ii)(d)(6), items of partnership income and gain for such year (and, if necessary, subsequent years) will be specially allocated to such partner in an amount and manner sufficient to eliminate, to the extent required by the regulations, any adjusted capital account deficit created by such adjustments, allocations or distributions as quickly as possible, provided that an allocation pursuant to this § 5.3(a) will be made only if and to the extent that a partner would have an adjusted capital account deficit after all other allocations to the partners' capital accounts provided for in this Article V have been tentatively made as if § 5.3(a) were not in the Agreement. Section 5.3(a) is intended to comply with and implement the "alternate test for economic effect" and the preceding sentence is intended to operate as a "qualified income offset" as set forth in § 1.704-1(b)(2)(ii)(d).

For federal income tax purposes under § 5.4(a)(i), the adjusted tax basis of each oil and gas property will be allocated among only those partners who were partners of the Consolidating Partnership which transferred such property to the Partnership in the same manner in which such tax basis was allocated among the partners of such Consolidating Partnership for the final taxable year preceding the merger. Section 5.4(b)(i) generally provides that upon the sale or other taxable disposition of any oil or gas property on which simulated depletion was computed, the total amount realized that represents a recovery of simulated adjusted tax basis will be allocated to the partners in the same proportion as the aggregate adjusted basis of such property was allocated to such partners. Any additional amount realized will be allocated to each partner so that the capital account balances become proportionate to the partners' percentage interests in Partnership and thereafter in accordance with their respective percentage interests.

Partnership has requested rulings that (1) the allocations described in §§ 5.1 and 5.2 have economic effect under § 704(b); and (2) the allocations described in §§ 5.4(a)(i) and 5.4(b)(i) constitute a reasonable method for making allocations under § 704(c).

ALLOCATIONS UNDER § 704(b)

Under §§ 704(b) and 1.704-1(b), allocations of a partnership's items of income, gain, loss, deduction, or credit provided for in a partnership agreement are respected if the allocations have substantial economic effect. Section 1.704-1(b)(2)(i) sets forth a two part test to determine whether an allocation has substantial economic effect. First, the allocation must have economic effect. Second, the economic effect of the allocation must be substantial. Allocations that do not have substantial economic effect are reallocated among the partners in accordance with their interests in the partnership.

Section 1.704-1(b)(2)(ii)(a) provides that for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive the economic benefit or bear the economic burden.

Section 1.704-1(b)(2)(ii)(b) provides that an allocation of income, gain, loss, or deduction to a partner will have economic effect if, throughout the full term of the partnership, the partnership agreement provides that (1) the partnership will maintain a capital account for each partner under the rules of § 1.704-1(b)(2)(iv); (2) the partnership will liquidate according to positive capital account balances; and (3) the partners are unconditionally obligated to restore any deficit balances in their capital accounts following the liquidation of the partnership or of the partner's interest in the partnership.

Section 1.704-1(b)(2)(ii)(d) provides an alternate test for economic effect. This test applies if the partnership agreement meets requirements (1) and (2) of the economic effect test described in § 1.704-1(b)(2)(ii)(b), but fails to meet requirement (3) of that test. Under this alternate test, if the partnership agreement contains a "qualified income offset," an allocation will be considered to have economic effect to the extent that the allocation does not cause or increase a deficit capital account for any partner (in excess of any limited deficit restoration obligation of that partner) as of the end of the partnership taxable year to which the allocation relates. In determining the extent to which the previous sentence is satisfied, a partner's capital account shall also be reduced for various items provided for in § 1.704-1(b)(2)(ii)(d)(4), (5), and (6). The partnership agreement contains a "qualified income offset" if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in paragraphs (4), (5), or (6) specified above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.

Section 1.704-1(b)(2)(iv)(b) provides that the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of paragraph

(b)(2)(iv) if, and only if, each partner's capital account is increased by (1) the amount of money contributed by him to the partnership, (2) the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under § 752), and (3) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g), but excluding income and gain described in paragraph (b)(4)(i); and decreased by (4) the amount of money distributed to him by the partnership, (5) the fair market value of property distributed to him by the partnership (net of liabilities secured by such distributed property that such partner is considered to assume or take subject to under section § 752), (6) allocations to him of expenditures of the partnership described in § 705(a)(2)(B), and (7) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(g), but excluding items described in (6) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii); and is otherwise adjusted in accordance with the additional rules set forth in paragraph (b)(2)(iv).

Section 1.704-1(b)(2)(iv)(g)(1) provides that where property is reflected on the books of the partnership at a book value that differs from the adjusted basis of the property, the partners' capital accounts must be adjusted to reflect depreciation, depletion, amortization, and gain or loss, as computed for book purposes.

Section 1.704-1(b)(2)(iv)(g)(3) provides that if an item of partnership property that is subject to depreciation, depletion, or amortization is properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property, the partnership must reduce the partners' capital accounts, in the aggregate, by the amount of depreciation, depletion, or amortization that bears the same relationship to the book value of the property as the partnership's total amount of tax depreciation, depletion, or amortization from the property bears to the adjusted tax basis of the property.

Section 613A(c)(7)(D) provides that in the case of a partnership, the depletion allowance is computed separately by the partners and not by the partnership. Instead, the partnership allocates each partner its proportionate share of the adjusted basis of each partnership oil or gas property. A partner's proportionate share of the adjusted basis of partnership property is determined in accordance with its interests in partnership capital or income and, in the case of property contributed to the partnership by a partner, § 704(c) (relating to contributed property) applies in determining a partner's share of the adjusted basis.

Notwithstanding the fact that § 613A(c)(7)(D) requires each partner to compute its depletion allowance separately, § 1.704-1(b)(2)(iv)(k)(2) contains rules that require partnerships to make adjustments to the partners' capital accounts to simulate depletion from oil and gas properties and for gain or loss from the disposition of those properties. Partnerships are required to reduce their partners' capital accounts by the partners'

shares of the partnership's simulated depletion allowance. The partnership may compute its simulated depletion allowance under either the cost depletion method or the percentage depletion method, but it must use the same method for all years during which the partnership holds the oil and gas property. The partners share in the partnership's simulated depletion allowance from oil and gas property in the same proportion as they share in the property's adjusted basis.

Section 1.704-1(b)(2)(iv)(k)(2) also provides that upon the taxable disposition of the oil and gas property, the partnership must increase its partners' capital accounts by their shares of the simulated gain from the property, or decrease the partners' capital accounts by their shares of the simulated loss from the property. The partnership computes its simulated gain or loss by subtracting its simulated adjusted basis from the amount realized on the disposition. The partners share in the simulated gain in the same proportions as they share in the portion of the amount realized from the disposition that exceeds the partnership's adjusted basis. The partners share in the partnership's simulated loss in the same proportions as they share in the amount realized from the disposition that represents recovery of the partnership's simulated adjusted basis.

Section 1.704-1(b)(4)(v) provides that, to the extent not governed by § 704(c), the partners' allocable shares of the amount realized upon the partnership's taxable disposition of an oil or gas property are determined as follows: (1) the portion of the total amount realized representing recovery of the partnership's simulated adjusted tax basis in the property is allocated to the partners in the same proportion as the aggregate adjusted tax basis of the property was allocated; (2) any excess amount realized is allocated according to the partnership agreement, provided that the allocation does not give rise to capital account adjustments the economic effect of which is insubstantial and all other allocations and capital account adjustments under the partnership agreement are recognized under § 1.704-1(b).

Section 1.704-1(b)(2)(iv)(k)(4) provides that, for purposes of maintaining the partners' capital accounts, if an oil or gas property of the partnership is § 704(c) property, simulated depletion and simulated gain or loss from the disposition of the property is calculated using the property's book basis rather than its adjusted tax basis.

Based on the partnership agreement and the representations made, we conclude that the partnership allocation provisions provided for in the partnership agreement meet the requirements for economic effect set forth in § 1.704-1(b)(2)(ii) provided that the allocation does not cause or increase a deficit balance in any partners' capital account (in excess of any limited deficit restoration obligation of that partner) as of the end of the partnership taxable year to which the allocation relates. No opinion is expressed or implied regarding whether Partnership allocations will satisfy the requirements for substantiality provided in § 1.704-1(b)(2)(iii).

ALLOCATIONS UNDER § 704(c)

Section 704(c)(1)(A) requires partnerships to 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.

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 pre-contribution gain or loss. In order to do so, § 1.704-3(a)(1) requires that § 704(c) allocations be made using any reasonable method consistent with that purpose. Section 1.704-3 describes three methods of making § 704(c) allocations that are generally reasonable; other methods may also be reasonable under appropriate circumstances. Section 1.704-1(a)(2) provides that § 704(c) generally applies on a property by property basis. Section 1.704-3(e)(4), however, provides that the Commissioner may permit § 704 to be applied on an aggregate method in appropriate cases.

Under § 5.4 of the partnership agreement, the adjusted tax basis is allocated among only those partners who were partners of the Consolidating Partnership which transferred such property to the Partnership in the same manner in which such tax basis was allocated among the partners of such Consolidating Partnership for the final taxable year preceding the merger. The amount realized for an oil and gas property will be allocated as provided in § 1.704-1(b)(4)(v). Similarly, under § 3.5(c), simulated depletion will be allocated to the capital accounts of the partners to whom a share of Partnership's tax basis in such oil or gas property has been allocated. Under § 3.5(d) and § 5.4(b)(i)(B), simulated gain realized upon the sale or other taxable disposition of any oil or gas property will be allocated to each partner so that the capital account balances of the partners become proportionate to their respective percentage interests. Any remaining simulated gain will be allocated in accordance with the partners' percentage interests in Partnership. Simulated loss will be allocated in proportion to the partners' allocable shares of the adjusted tax basis (or, if applicable book value) of the property.

Because (i) the money and receivables contributed to Partnership were subsequently distributed to the former partners of the Consolidating Partnerships and were not taken into account in determining the former partners' percentage interests in Partnership; (ii) the Agreement does not provide for capital contributions subsequent to the merger that would alter the partners' percentage interests in Partnership; (iii) each oil and gas property acquired by Partnership in the merger is subject to depletion; (iv) the number of oil and gas properties acquired in the merger is large and the value of each property is small in proportion to the total value of the assets acquired; (v) Partnership lacks any intent to dispose of Partnership assets other than in the ordinary course of its investment activities; and (vi) each partner's interest in Partnership is determined with respect to the relative values of the Consolidating Partnerships

(excluding the cash and receivables) and of the interests of the former partners in each Consolidating Partnership, we have concluded that the allocations in § 5.4 of the Agreement prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Accordingly, this method of making § 704(c) allocations constitutes an acceptable method in this instance.

Based on the facts submitted and the representations made, we hold that:

- (1) The allocation provisions in §§ 5.1 and 5.2 satisfy the economic effect requirements under § 704(b); and
- (2) The allocation provisions in §§ 5.4(a)(i) and 5.4(b)(i) constitute an acceptable method for making § 704(c) allocations in this instance.

Except as specifically ruled on above, no opinion is expressed or implied as to the federal income tax consequences of the transactions described above under any other provision of the Code.

This ruling is directed only to the taxpayer on whose behalf it was requested. Section 6110(k)(3) of the Internal Revenue 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 your authorized representative.

Sincerely,

/s/ David R. Haglund

David R. Haglund
Senior Technical Reviewer, Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)