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Date:

December 14, 2005

Dear

This letter ruling is based on representations made in your ruling request letter of September 13, 2004, the pre-submission letter of July 12, 2004, and additional correspondence.

LEGEND:

B =

T =

P =

Debt =

Assets =

RULING:

P will be treated as borrowing the balance of the Debt and investing the proceeds in the property received from the Bs when T terminates, under section 1.163-8T(c)(3)(ii) of the Temporary Income Tax Regulations. P may deduct the interest on the Debt as investment interest, and may allocate the Debt and associated interest among all its Assets in proportion to their fair market values as of the date T terminates.

FACTS:

T is a testamentary trust that will terminate in the near future by its terms. T's Assets consist primarily of real estate in several states. T is required by its governing instrument to distribute all of its income among the beneficiaries (Bs) on a semi-annual or more frequent basis.

Upon termination of T, the Assets are to be distributed *per stirpes* among the Bs. By state law, and the terms of the governing instrument, terminating distributions may be

made in cash or in kind, and on a pro rata or non-pro rata basis. The trustees received a ruling from the IRS that no gain or loss will be recognized to T or the Bs as a result of the non-pro rata distributions upon T's termination. This ruling was requested because the Bs requested distributions that will change their proportional ownership, with some getting substantial cash distributions and some getting substantial property interests.

The termination plan for T was approved by the state court in a proceeding in which all Bs were represented. Under the plan, almost all of the Assets will be transferred to a successor entity. The trustees created P to be the successor entity. P is a single-member limited liability company, disregarded as an entity separate from its owner, T, for federal tax purposes under section 301.7701-3(b)(1)(ii) of the Procedural and Administrative Regulations.

The trust's Assets and Debt will be transferred to P under state law, a transaction that will be treated as a non-event for federal tax purposes because at the time P will be disregarded as an entity separate from its owner. (T will be treated as continuing to hold the Assets and associated liabilities under federal law. P will become co-debtor under state law when it receives the Assets because P is a recognized entity for state law purposes.) Until T terminates it will be treated as the debtor, and its interest deduction will be determined under section 163 of the Internal Revenue Code by how T invests the Debt proceeds.

The termination plan calls for the trustees to borrow funds with the Assets as security. This will allow a distribution of a mixture of cash and property, the proportion of cash to property varying among individual Bs. The Bs who will become members in P will receive varying mixtures of cash and interests in P. (A few Bs will receive only cash, and one will receive trust Assets directly; these Bs will not become P members.) None of the Debt proceeds will be contributed to P.

DISCUSSION:

You requested a ruling that P may allocate the Debt and associated interest among all its Assets in proportion to their fair market values as of the date T terminates. You argue that P, in receiving encumbered property as part of the termination plan, should be treated as assuming the Debt to acquire the Assets from the Bs. This would make the interest paid by P on this Debt deductible investment interest under section 163(d).

P was created as a limited liability company with a single owner, and, thus, disregarded as an entity separate from its owner, T, for federal tax purposes. When T distributes interests in P to the Bs, P will convert from a disregarded entity to a partnership. See section 301.7701-3(f)(2). In addition, each B that receives an interest in P will be treated as receiving a proportionate share of P's Assets, subject to a proportionate share of P's liabilities, and immediately thereafter, each B will be treated as contributing those Assets subject to the liabilities to a partnership in exchange for ownership interests in the partnership. See Rev. Rul. 99-5, 1999-1 C.B. 434.

Because P will thus receive property subject to the Debt, and receive no cash Debt proceeds, P effectively will be treated as borrowing the balance of the Debt and investing the proceeds in the property so received. "If a taxpayer incurs or assumes a debt in consideration for the sale or use of property, for services, or for any other purpose, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated for purposes of this section as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property, services, or other purpose." Section 1.163-8T(c)(3)(ii). The debt is assumed by P when it receives the investment property, and interest P pays is therefore allocated entirely to those investments.

P will issue an ownership interest to each B in exchange for the Assets the B is treated as contributing to P. The Assets treated as contributed to P will be subject to the Debt which P assumes when it receives the Assets. The Debt so assumed will be substantially less than the fair market value of the Assets received. P may therefore treat the Debt as part of its investment in the Assets under section 1.163-8T(c)(3)(ii). P may deduct interest on the Debt as investment interest, within the limitations of section 163(d).

Issues relating to the allocation of debt to the acquisition of an interest in a partnership are reserved by section 1.163-8T(h). However, under Notice 89-35, 1989-1 C.B. 675, interest expense on debt proceeds allocated under section 1.163-8T to a contribution to the capital of a passthrough entity shall be allocated using any reasonable method. The method proposed by the taxpayer here is a reasonable method.

This treatment is conditioned on the passthrough entity not being formed or availed of by a taxpayer with a principal purpose of avoiding or circumventing the rules of section 1.163-8T. That condition is satisfied here, as the trustees created P as the successor entity that receives the Assets to permit T to be terminated as required by its terms. The Debt, approved by the state court, protects the trustees from litigation by dissatisfied Bs, a legitimate non-tax purpose.

CAVEATS:

This letter 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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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. In particular, although the trust has other debt that will be passed to P, this ruling only addresses the new Debt.

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

Sincerely,

Clifford M. Harbourt
Senior Technical Reviewer
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: