INTERNAL REVENUE SERVICE

Number: **200125053**
Release Date: 6/22/2001
Index Nos: 704.01-02, 721.00-00
851.00-00, 7704.01-00

CC:PSI:2 - PLR-106526-00
PLR-112329-00

March 23, 2001

P1 =

Fund A =

Fund B =

Limited Partnership =

Company A =

Company B =

State X =

State Y =

Date 1 =

Date 2 =

Date 3 =

Dear

This is in reply to a letter of March 15, 2000, and subsequent correspondence submitted on behalf of P1, Fund A, Fund B, Limited Partnership, Company A, and Company B, by their authorized representative requesting certain rulings relating to the master-feeder investment fund structure between P1, Fund A and Fund B (the "Funds").

P1 (the "Trust") was established on Date 3, as a State Y business trust. Trust is registered with the Securities and Exchange Commission (SEC) under the 1940 Act as an open-end diversified management investment company. A Declaration of Trust (Declaration) sets out the terms of Trust. Trust will aggregate gains and losses from qualified financial assets in order to determine its partnership allocations on both forward and reverse § 704(c) allocations. Trust employs a full netting approach.

Trust represents that it was organized in a manner so as to enable its classification as a partnership and not to enable investors that are RICs to make distributions that would be prohibited by Rev. Rul. 89-81, 1989-1 C.B. 266, had they invested directly in the securities held by Trust.

Fund A was organized as a State X corporation on Date 1 under the sponsorship of Limited Partnership. Fund A has elected to be taxed as a regulated investment company ("RIC") under §§ 851-855 of the Code and intends to continue to so qualify. Fund A has a fiscal year.

Fund B was organized as a State X corporation on Date 2 under the sponsorship of Limited Partnership. Fund B intends to make an election on its first corporate income tax return to be taxed as a RIC. Fund B has a fiscal year.

Limited Partnership is a limited partnership, the partners of which are Company A and Company B. Limited Partnership is in the business of providing investment management and related services and is registered with the SEC as an investment adviser under the Investment Advisers Act of 1940. Limited Partnership is the principal investment adviser of Fund A and Fund B.

Fund A will contribute 100 percent of its assets, which consists of a diversified portfolio of stocks, securities, and cash, to Trust. Fund B will contribute 100 percent of its assets, which consists of solely cash, to Trust. An affiliate of Limited Partnership, Company B, will also make a contribution of cash or assets to Trust in exchange for an interest therein. The assets that Fund A and Fund B contribute to Trust will be managed at Trust level. Limited Partnership will be the principal investment adviser to Trust.

Interests in Trust will be offered and sold only to registered investment companies, insurance companies, common or commingled trust funds, group trusts, and similar entities that qualify as accredited investors within the meaning of Regulation D under the Securities Act of 1933 (1933 Act). Such entities are referred to in the Declaration as "Institutional Investors." Each institutional investor that contributes assets to Trust is referred to under the Declaration as a "Holder." Trust will not issue interests to any individual, S corporation, partnership, or grantor trust, a grantor of which includes an individual, S corporation, or partnership. Holders of interests in Trust will be limited to Institutional Investors. In addition and in all events, the number of holders of interests in Trust will be limited to fewer than 100.

Trust will establish a capital account for each Holder upon the Holder's contribution of capital (cash or securities) to

Trust. The initial value of any Holder’s capital account will be the fair market value of the assets contributed on the date of contribution. Trust will adjust each Holder’s capital account, and, therefore, its interest in Trust, daily. Trust will adjust a Holder’s capital account each day for contributions and distributions, and also, for such Holder’s ratable share of unrealized gain or loss. In other words, Trust will mark its portfolio to market each day and record the changes in value of its portfolio in the capital accounts of the Holders.

Contributions, distributions, and withdrawals may occur on any business day. Pursuant to the Declaration and the securities laws applicable to Trust, each Holder is permitted to redeem its entire interest (*i.e.*, completely withdraw the balance of its capital account) in Trust on any business day, subject to the requirements of the 1940 Act. Interests in Trust are not transferable by the Holders except as part of a reorganization, as defined in the 1940 Act.

The Declaration provides that, consistent with its investment objectives, Trust will be managed so as to comply with the requirements of Part 1 of subchapter M of the Code as though such requirements were applied at Trust level. Dissolution of Trust may occur by a resolution adopted by a majority of the Trustees followed by notice of dissolution to the Holders.

The following representations are made on behalf of Trust, Fund A, Fund B, and Company B:

1. For purposes of determining the required distributions under § 4982(a)(1), Fund A and Fund B will each account for its share of partnership items of income, gain, loss, and deduction as they are taken into account by Trust.

2. Except as required by § 704(c) and §1.704-1(b)(4) of the Income Tax Regulations, Fund A’s, Fund B’s, and Company B’s allocable share of Trust’s income, gain, loss, deduction, and credit will be comprised of a proportionate share of each item of income includible in Trust’s gross income.

3. Trust will invest its assets in a manner that will allow Fund A and Fund B to each meet the requirements of § 851(b).

4. Fund A, Fund B, and Company B will contribute solely cash and/or a diversified portfolio of stocks and securities to Trust.

5. There is no plan or intention for Fund A, Fund B or Company B to transfer assets, other than cash and/or a diversified portfolio of stocks and securities to Trust.

6. Any other Holder who has contributed or will contribute assets to Trust has contributed or will contribute solely cash and/or a diversified portfolio of stocks and securities to Trust.

For purposes of representations 4, 5, and 6 above, a portfolio of stocks and securities is diversified if it satisfies the 25 and 50 percent tests of § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F), except that in applying § 368(a)(2)(F)(iv), government securities are included in determining total assets unless the government securities are acquired to meet the requirements of § 368(a)(2)(F)(ii).

Section 7704(a) provides that a publicly traded partnership shall be treated as a corporation.

Section 7704(b) provides that, for purposes of § 7704, the term "publicly traded partnership" means any partnership if (1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 1.7704-1(h)(1), concerning private placements, provides that except as otherwise provided in § 1.7704-1(h)(2), interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof if (i) all interests in the partnership were issued in a transaction (or transactions) that was not required to be registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.); and (ii) the partnership does not have more than 100 partners at any time during the taxable year of the partnership.

Trust represents that it will be limited to fewer than 100 Holders, and that no interests in Trust have been, or will be traded on an established securities market or issued in a transaction registered under the Securities Act of 1933. Based on the information provided and the representations made, we conclude that Trust will not be a publicly traded partnership for purposes of § 7704.

Section 851(a) defines a RIC, in part, as a domestic corporation registered under the 1940 Act as a management company.

Section 851(b) limits the definition of a RIC to a corporation meeting certain election, gross income, and diversification requirements.

Section 851(b)(2) provides that, to qualify as a RIC, 90 percent of a corporation's gross income must be derived from dividends, interest, payments with respect to securities loans (as defined in § 512(a)(5)), gains from the sale or other disposition of stocks, securities, foreign currencies, or other income derived with respect to the business of investing in such stocks, securities, or currencies.

Section 851(b)(3)(A) requires that, to qualify as a RIC, at the close of each quarter of the taxable year, at least 50 percent of the value of a corporation’s total assets must be represented by cash and cash items (including receivables), Government securities, securities of other RICs, and other securities generally limited in respect of one issuer to an amount not greater in value than 5 percent of the value of the total assets of the corporation and to not more than 10 percent of the outstanding voting securities of such issuer.

Section 851(b)(3)(B) provides that to qualify as a RIC, not more than 25 percent of the corporation’s total assets may be invested in the securities (other than Government securities and securities of other RICs) of any one issuer, or two or more issuers which the corporation controls and which are determined, under regulations, to be engaged in the same or similar trades or businesses or related trades or businesses.

Section 853(a) provides that a RIC more than 50 percent of the value (as defined in § 851(c)(4)) of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations and which meets the requirements of § 852(a) for the taxable year may elect to treat its shareholders as if they had paid certain foreign taxes incurred by the RIC for purposes of determining a shareholder's foreign credit under § 901.

Section 702(b) provides that the character of items stated in § 702(a) that are included in a partner's distributive share shall be determined as if such items were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. Section 702(c) provides that where it is necessary to determine the amount or character of the gross income of a partner, such amount shall include that partner's distributive share of the gross income of the partnership.

Section 1006(n)(1) of the Technical and Miscellaneous Revenue Act of 1988 added a sentence to the flush language of § 851(b) that states that income derived from a partnership or trust shall be treated as satisfying the 90 percent test of § 851(b)(2) only to the extent that such income is attributable to items of income of the partnership or trust which would be described in § 851(b)(2) if earned directly by the RIC. The legislative history of that sentence indicates that it was intended to clarify the general rule used to characterize items of income, gain, loss, deduction, or credit includable in a partner's distributive share, as applied to RICs that are partners. It therefore explains the relationship of § 702 to the

90 percent test under § 851(b)(2). See S. Rep. No. 445, 100th Cong., 2d Sess. 93 (1988).

Under subchapter K of the Code, a partnership is considered to be either an aggregate of its members or a separate entity. Under the aggregate approach, each partner is treated as an owner of an undivided interest in partnership assets and operations. Under the entity approach, the partnership is treated as a separate entity in which partners have no direct interest in partnership assets and operations. See S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954) and H.R. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954).

In order for Funds A and B to qualify as RICs under the diversification tests of § 851, the aggregate approach will have to be applied to each Fund's partnership interest in Trust. As an aggregate, each Fund will be entitled to take into account its share of the individual items of income and assets of Trust.

Rev. Rul. 75-62, 1975-1 C.B. 188, concerns a life insurance company that contributed cash to a partnership in exchange for a 50 percent interest in the partnership. The partnership held real estate as its principal asset. For the taxable year in question, § 805(b) required life insurance companies to value their assets each taxable year. For this purpose, § 805(b)(4) required that shares of stock and real estate be valued at their fair market values, and that other assets be valued at their adjusted basis. The issue presented in the ruling is whether, for purposes of § 805(b)(4), the life insurance company's interest in the partnership is considered to be an investment in the real estate held by the partnership (an aggregate approach) or an investment in other property (an entity approach).

Rev. Rul. 75-62 holds that the partnership interest held by the life insurance company must be accounted for as other property for purposes of § 805(b)(4). The ruling cites §§ 705 and 741, both of which generally treat an interest in a partnership as an interest in an entity, as evidence of an intent in subchapter K to take the entity approach in questions concerning the nature of an interest in a partnership. The ruling states that the legislative history of § 805(b)(4) does not indicate that application of the entity approach to the facts of the ruling is inappropriate, and that there is no compelling reason to take the aggregate approach.

The flush language of § 851(b)(3)(formerly § 851(b)(4) for taxable years of a RIC that began before August 5, 1997) and its legislative history indicate that here, unlike the situation described in Rev. Rul. 75-62, Congress intended that an aggregate approach be taken in determining the nature of the partnership interests held by the Holders. The flush language of § 851(b) mandates an aggregate approach in applying the 90 percent gross income test of § 851(b)(2) to RICs that hold partnership interests. It would be anomalous to suggest that Congress intended that a RIC's interest in a partnership be viewed as a direct investment in the partnership's assets for purposes of the § 851(b)(2) test but not be viewed as a direct investment in those assets for purposes of the test set out in, inter alia, § 851(b)(3).

The tax treatment accorded real estate investment trusts (REITs) lends further support to applying the aggregate approach to the present case. REITs were created to provide an investment vehicle similar to the RIC for small investors to invest in real estate and real estate mortgages. See H.R. Rep. 2020, 86th Cong., 2d Sess. 3 (1960). Like RICs, REITs are subject to restrictions on the type of assets they can hold if they want to retain the benefits accorded them under subchapter M and are subject to certain gross income source tests. REITs and RICs also have similar distribution and holding period requirements.

Section 1.856-3(g) provides that:

> In the case of a real estate investment trust which is a partner in a partnership, as defined in section 7701(a)-(2) and the regulations thereunder, the trust will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets shall be determined in accordance with his capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership shall retain the same character in the hands of the partners for all purposes of section 856. Thus, for example, if a trust owns a 30-percent capital interest in a partnership which owns a piece of rental property the trust will be treated as owning 30 percent of such property and as being entitled to 30 percent of the rent derived from the property by the partnership. Similarly, if the partnership holds any property primarily for sale to customers in the ordinary course of its trade or business, the trust will be treated as holding its proportionate share of such property primarily for such purpose. Also, for example, where a partnership sells real property or a trust sells its interest in a partnership which owns real property, any gross income realized from such sale, to the extent that it is attributable to the real property, shall be deemed gross income from the sale or disposition of real property held for either the period that the partnership has held the real property or the period that the trust was a member of the partnership, whichever is the shorter.

Thus, the regulation adopts the aggregate "look-through" approach in determining how a REIT should account for its partnership interests for purposes of all of the income and asset qualification tests under § 856.

The legislative purpose underlying the creation of both RICs and REITs was to provide small investors a means of pooling their resources to invest in a particular type of asset without the imposition of corporate income tax. The qualification tests are similar for each. Therefore, although the RIC regulations do not specifically address the issue herein, it is appropriate to adopt an approach for RICs that parallels that set forth for REITs.

Accordingly, Fund A and Fund B, as partners in Trust, will each be deemed to own a proportionate share of the assets of Trust and will be deemed to be entitled to the income of Trust attributable to that share for purposes of determining whether Fund A and Fund B each satisfies the requirements of §§ 851(b)(2), 851(b)(3), and 853(a). For purposes of these sections, the interest of Fund A and Fund B in Trust shall be determined in accordance with Fund A’s and Fund B’s capital interest in Trust.

Section 721(a) provides that no gain or loss is recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 721(b) provides, however, that § 721(a) does not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of § 351) if the partnership were incorporated.

Section 351 states that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation. Section 351 does not apply to a transfer of property to an investment company. Section 351(e)(1).

Section 1.351-1(c)(1) states that a transfer to an investment company will occur when (i) the transfer results, directly or indirectly, in diversification of the transferors’ interests and (ii) the transferee is a regulated investment company ("RIC"), real estate investment trust ("REIT"), or a corporation more than 80-percent of the value of whose assets (excluding cash and non-convertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in RICs or REITs.

Section 1002 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997) (the "Act"), amends § 351(e) for transfers after June 8, 1997, in taxable years ending after such date, subject to certain transitional relief provisions. Section 1002 of the Act is intended to expand the types of assets considered in determining whether a transfer is to a transferee described in § 1.351-1(c)(1)(ii)(c) to include certain assets in addition to "readily marketable stocks or securities" and interests in RICs and REITs. However, the Act is not intended to alter the requirements of § 1.351-1(c)(1)(i) that a transfer of property will be considered to be a transfer to an investment company under § 351(e) only if the transfer results, directly or indirectly, in diversification of the transferors' interests. See S. Rep. 105-33, 105th Cong., 1st Sess. 131 (1997); H. R. Rep. 105-148, 105th Cong., 1st Sess 447 (1997); H.R. Rep. 105-220, 105th Cong., 1st Sess. 516-17 (1997).

Section 1.351-1(c)(5) provides that a transfer ordinarily results in diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in the exchange. It further provides that, if a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification.

Section 1.351-1(c)(6)(i) provides that (i) a transfer of stocks and securities will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities and (ii) a portfolio of stocks and securities is considered to be diversified if it satisfies the 25 and 50-percent tests of § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F), except that government securities are included in total assets for purposes of the denominator of the 25 and 50-percent tests (unless acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25 and 50-percent tests.

A corporation is diversified within the meaning of § 368(a)(2)(F)(ii) if not more than 25-percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50-percent of the value of its total assets is invested in the stock and securities of 5 or fewer issuers.

Accordingly, provided that Trust is treated as partnership for purposes of § 721, the transfers by Fund A, Fund B, and Company B to Trust are not transfers of property to a partnership that would be treated as an investment company (within the meaning of § 351) if Trust were incorporated, provided that these are the only transfers to Trust (except for transfers solely of cash and/or a diversified portfolio of stocks and securities, within the meaning of § 1.351-1(c)(6)(i)).

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution.

Section 723 provides that the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution.

Accordingly, the basis of a transferor's interest in Trust will be the amount of money and the aggregate of the adjusted bases of the property contributed by the transferor, reduced by the sum of such transferor's liabilities assumed by Trust or liabilities to which the assets transferred to Trust were subject. Further, Trust will have an adjusted basis in any property contributed to it equal to the adjusted basis of such property to the transferor at the time of the contribution. Finally, under § 1223(2) the holding period of Trust in property received in the contribution by a transferor will include the transferor's holding period for such property and the holding period of Fund A, Fund B and Company B in the share of beneficial interest it receives from Trust will include the period during which the property exchanged was held by the transferor, provided that such property constitutes a capital asset as defined in § 1221 or property described in § 1231 on the date of the exchange.

Section 1.704-1(b)(2)(iv)(f) provides that a partnership agreement may, upon the occurrence of certain events, increase or decrease the partners' capital accounts to reflect a revaluation of partnership property on the partnership's books. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of § 1.704-1(b)(2)(iv) unless--

(1) the adjustments are based on the fair market value of partnership property on the date of adjustment;

(2) the adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in the property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of the property for its fair market value on that date;

(3) the partnership agreement requires that the partners' capital accounts be adjusted in accordance with § 1.704-1(b)(2)(iv)(g) for allocations to them of depreciation,

depletion, amortization, and gain or loss, as computed for book purposes, with respect to the property;

(4) the partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to the property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under § 704(c); and

(5) the adjustments are made principally for a substantial non-tax business purpose--

(i) in connection with contribution of money or other property to the partnership by a new or existing partner as consideration for an interest in the partnership; or

(ii) in connection with the liquidation of the partnership or a distribution of money or other property by the partnership to a retiring or continuing partner as consideration for an interest in the partnership; or

(iii) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

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) provides 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. 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) 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) 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)(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).

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.

Accordingly, based on the information submitted and the representations made we conclude that Trust is a securities partnership for purposes of § 1.704-3(e)(3) and that pursuant to § 1.704-3(e)(3), Trust will be allowed to make forward and reverse § 704(c) allocations on an aggregate basis. Furthermore, we conclude that the full netting method used by Trust to aggregate gains and losses from qualified financial assets is a reasonable approach that is consistent with the purpose of § 704(c). This conclusion is limited to Trust with regard to Fund A, Fund B and Company B. No conclusion regarding § 704(c) allocations as to any other present or future partners of Trust is expressed or implied.

Except as specifically ruled upon above, no opinion is expressed on the federal tax consequences of the transactions described above under any other provisions of the Code. This opinion is limited to Trust, Fund A, Fund B and Company B. Specifically, no opinion is expressed as to whether Fund A or Fund B qualifies as a RIC that is taxable under subchapter M, part 1 of the Code. Furthermore, we express no opinion as to the consequences of other transfers to Trust, either as to whether such transfers would be "transfers to an investment company" or whether such other transfers would, when taken together with the transfers by Fund A, Fund B, and Company B described above cause those transfers to be considered "transfers to an investment company," except for transfers solely of cash and/or a diversified portfolio of stocks and securities within the meaning of § 1.351-1(c)(6)(i).

Temporary of final regulations pertaining to one or more of the issues addressed in this ruling letter have not yet been adopted. Therefore, this ruling will be modified or revoked if adopted temporary or final regulations are inconsistent with any conclusions in the ruling. See § 12.04 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 46 (January 2, 2001). However, when the criteria in § 12.05 of Rev. Proc. 2001-1 are satisfied, a ruling is not revoked or modified retroactively except is rare or unusual circumstances.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to Trust's authorized representative.

Sincerely yours,
J. THOMAS HINES
Chief, Branch 2
Office of the Associate
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes