**Internal Revenue Service**

Department of the Treasury

Number: **200047023**
Release Date: 11/24/2000
Index Numbers: 0561.05-00; 0562.03-02; 0702.00-00; 0704.01-02; 0851.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:B03/PLR-100057-00
Date:
August 23, 2000

LEGEND:

Master Fund =

Master Trust =

Feeder Fund =

Company =

Adviser =

Administrator =

State =

Date 1 =
Date 2 =
Date 3 =

A =
B =
C =

Dear

This responds to your request for a ruling dated December 17, 1999, as supplemented, submitted by you on behalf of the Master Fund, the Feeder Fund, and the Company (collectively the "taxpayers").

FACTS

Master Trust is a business trust established in accordance with the laws of the State under an Instrument and Agreement and Declaration of Trust dated Date 1 (the

“Declaration of Trust”). On Date 1, the Master Trust adopted a resolution authorizing the creation of a new series of the Master Trust. It is intended that the new series will be comprised of the Master Fund, which will receive investments from the Feeder Fund and other feeder funds that may be created in the future. Taking into account applicable lookthrough rules, the Master Fund will not have more than 100 partners at any time.

The Master Fund is organized as a series of a business trust established under the laws of the State and will issue one or more series of shares. The Master Fund will make a continuous offering of its shares and will be a non-diversified closed-end management investment company registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 Act (the “1940 Act”). The Master Fund is intended to be classified as a partnership for federal income tax purposes. The fiscal and taxable year of the Master Fund ends on Date 2.

The Feeder Fund is a corporation organized as a business trust under the laws of the State. The Feeder Fund is a continuously offered non-diversified closed-end management investment company registered with the SEC under the 1940 Act. The Feeder Fund also has registered its shares pursuant to the Securities Act of 1933, as amended. Since its inception, the Feeder Fund has elected and is operated in such a manner as to qualify as a Regulated Investment Company (RIC) under § 851 and intends to continue to qualify as such. The fiscal and taxable year of the Feeder Fund ends on Date 2.

It is intended that the Feeder Fund will contribute its assets in kind to the newly formed Master Fund in exchange for shares of the Master Fund. It is intended that the Company will contribute cash in the amount of $B to the newly formed Master Fund in exchange for shares of the Master Fund. The investment objective of the Feeder Fund is the same as that of the Master Fund.

The net assets of the Master Fund will be the aggregate of all of the net assets of all the respective feeder funds whose assets are invested in the Master Fund. The advisory fee payable by the Master Fund to the Adviser is anticipated not to exceed A percent of the average daily net assets under management. The Adviser may undertake to limit the total fund operating expenses of the Master Fund by waiving all or a portion of the advisory fee payable by the Master Fund to the Adviser or reimbursing expenses of the Master Fund.

No advisory fee will be paid by the Feeder Fund after its net assets are contributed to the Master Fund, but an administration fee may be paid by the Feeder Fund to the Administrator. The feeder level administrative fee will not cover any portfolio management functions and associated fees or expenses but may cover administrative services such as taking in money, depositing money in the Master Fund, and handling the shareholder record-keeping and accounting at the feeder level.

The taxpayers represent as follows:

1. The Feeder Fund has qualified and elected to be treated as a RIC under § 851(b) since its inception and intends to continue so to qualify. The Feeder Fund is a publicly offered RIC as defined in § 67(c)(2)(B) and § 1.67-2T(g)(3)(ii).

2. The Master Fund is a separate entity that will be treated as a partnership under § 7701(a)(2).

3. The Master Fund will not be classified as a publicly traded partnership under § 7704(b).

4. The organization of the Master Fund is being done in a manner to enable it to be classified as a partnership, and the allocation provisions governing the Master Fund are not being enacted to enable beneficial owners of the Master Fund that are RICs to gain a tax advantage that would be unavailable to them under the holding of Rev. Rul. 89-81, 1989-2 C.B. 226, if they had invested directly in assets held by the Master Fund.

5. Except as required by § 704(c) and § 1.704-1(b)(4), each holder's allocable share of the Master Fund's income will be equal to a proportionate share of each item of income includible in the Master Fund's gross income.

6. The Feeder Fund will contribute to the Master Fund a portfolio of assets that satisfies the diversification requirements of § 368(a)(2)(F)(ii). For purposes of this test, (U.S.) Government securities are not included within the meaning of "securities" under § 368(a)(2)(F)(ii) but are included within the meaning of total "assets" in § 368(a)(2)(F)(iv).

7. The Master Fund will comply in all respects with the capital account maintenance rules described in § 1.704-1(b)(2)(iv). Under § 1.704-1(b)(2)(iv)(f), § 1.704-1(b)(2)(iv)(g), and § 1.704-1(b)(4)(i), the Master Fund will revalue its investment portfolio to the fair market value at the close of each day and its security positions will be "marked-to-market" on a daily basis. The revaluations and corresponding allocations of tax items that will be made by each partner will not be 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. Any holder liquidating its entire interest in the Master Fund will receive a liquidating distribution equal to its positive book capital account balance. The Master Fund will allocate tax gains and losses among partners in a manner that takes into account each partner's share of the variation between the total adjusted tax bases of Master Fund's securities and the total book value of those securities. The methodology used for maintaining capital and tax accounts will comply with the requirements of §§ 704(b) and 704(c) and the regulations thereunder. No holder of a beneficial interest in the Trust will receive an allocation which would create or increase a deficit balance in such

holder’s Book Capital Account and, if such an allocation is unexpectedly made to such holder, a special allocation shall be made to such holder to eliminate such deficit.

8. For purposes of determining the required distribution under § 4892(a)(1), each holder of a beneficial interest in the Master Fund that is a RIC will account for its share of partnership items of income, gain, loss, and deduction as they are taken into account by the Master Fund, as required by Rev. Rul. 94-40, 1994-1 C.B. 274.

9. The Master Fund will qualify as a “securities partnership” for purposes of the definition provided in § 1.704-3(e)(3)(iii).

10. Substantially all of the property of the Master Fund will consist of “qualified financial assets” within the meaning of § 1.704-3(e)(3)(ii)(A).

11. The Master Fund will maintain sufficient records to enable it and its holders to comply with the requirements of §§ 704(c)(1)(B) and 737.

12. As of Date 3, the assets of the Feeder Fund had an aggregate built-in loss of approximately $C and no capital loss carryovers.

## LAW AND ANALYSIS

Ruling Request under §§ 851(b)(2) and 851(b)(3)

Section 851(b) of the Code provides that certain requirements must be satisfied in order for a domestic corporation to be taxed as a RIC and thereby to be exempt from the corporate level tax on most income.

Section 851(b)(2) of the Code provides that, to qualify as a RIC, at least 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) of the Code requires that, in order 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 any 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) of the Code provides that, in order 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 the securities of other RICs) of any one issuer, or of two or more issuers that 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 702(b) of the Code 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 they were 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) of the Code 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 that 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); H.R. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954).

In order for a holder to qualify as a RIC under the diversification tests of § 851 of the Code, the aggregate approach will have to be applied to each holder's partnership interest in a series. As an aggregate, each holder will be entitled to take into account its share of the individual items of income and assets of the series.

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) of the Code 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 bases. 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) of the Code. 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) of the Code 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 § 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. No. 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) of the regulations 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 the 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 of the Code.

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 assets 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.

Based on the information and representations submitted, we rule that the Feeder Fund will be deemed to own a proportionate share of the assets of the Master Fund and will be deemed to be entitled to the income of the Master Fund attributable to that share for purposes of determining whether the Feeder Fund satisfies the requirements of §§ 851(b)(2) and 851(b)(3). For purposes of these sections, the interest of the Feeder Fund in the Master Fund shall be determined in accordance with the Feeder Fund's capital interest in the Master Fund.

Ruling Requests under § 704(c)

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 deductions 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 1.704-3(a)(2) indicates that § 704(c) generally applies on a property-by-property basis. 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). Section 1.704-3(e)(3)(i) identifies the approach that the Master Fund will use for aggregating reverse § 704(c) gains as generally reasonable. 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.

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).

The aggregate approaches described in § 1.704-3(e)(3) generally apply only 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. 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, the burden of making § 704(c) allocations separate from reverse § 704(c) allocations is represented to be substantial. The Master Fund will receive large contributions of securities. Unless the Commissioner permits the Master Fund to aggregate § 704(c) gains and losses with reverse § 704(c) gains and losses, it will have to track pre-contribution unrealized gains and losses on a property-by-property basis, largely nullifying the benefits of the aggregate approach for making reverse § 704(c) allocations. Furthermore, the common investment objectives among the holders of interests in the Master Fund, the size of their investments, and the characteristics of the assets contributed by each to the Master Fund reduce the likelihood of abuse of an aggregate approach.

After applying the relevant law to the facts presented and the representations made, we conclude that the Master Fund may aggregate built-in gains and losses from qualified financial assets contributed to it by the Feeder Fund with built-in gains and losses from revaluations of qualified financial assets held by Master Fund for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations. In addition, we conclude that the Master Fund's method of making § 704(c)(1)(A) and reverse § 704(c) allocations is reasonable within the meaning of § 1.704-3(e)(3).

We further conclude that the Master Fund may aggregate built-in gains and losses from qualified financial assets contributed by future partners with built-in gains and losses from revaluations of qualified financial assets held by the Master Fund for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations, and that the Master Fund's method of making these allocations are reasonable within the meaning of § 1.704-3(e)(3), to the extent that the future partners are "qualified contributors." A qualified contributor is a partner for which the following conditions are satisfied: (1) the partner is registered under the Investment Company Act of 1940, as amended, and would be considered a "publicly offered regulated investment company" as defined in § 67(c)(2)(B) and § 1.67-2T(g)(3)(ii); (2) the contribution is made and accepted for valid business purposes and not made primarily for tax-motivated reasons (other than the fact that the contribution to the Master Fund is tax-free); and (3) to the extent the Master Fund relies on this ruling for the contribution, it will document any such contribution on its tax return filed subsequent to the contribution.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the

Code. Specifically, no opinion is expressed concerning (i) whether the Feeder Fund qualifies as a RIC that is taxable under subchapter M, part I of the Code, (ii) the aggregation of built-in gains and losses from assets contributed to the Master Fund except as detailed above, and (iii) whether any transfer to the Master Fund is taxable under § 721(b) or on the representation that the Master Fund is not a publicly traded partnership.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Further, except as specifically ruled upon above, no opinion is expressed or implied regarding the federal income tax consequences of the transactions described above to any taxpayer other than the Feeder Fund that is now or may become a holder of an interest in the Master Fund.

A copy of this letter should be attached to the federal income tax return of the Feeder Fund for every taxable year in which it participates in the arrangement described in this letter.

Sincerely,
Acting Associate Chief Counsel
(Financial Institutions and Products)
By: Alice M. Bennett
Chief, Branch 3

Enclosure: 6110 copy