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Date:
September 30, 2002

Legend

Master Fund =

Contributing Fund 1 =

Contributing Fund 2 =

Manager =

Trust 1 =

Trust 2 =

Trust 3 =

State 1 =

State 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Dear :

This letter responds to a letter dated September 28, 1999, and subsequent correspondence submitted on behalf of Master Fund, Contributing Fund 1, and Contributing Fund 2, by your authorized representative, requesting certain rulings regarding the transfer of certain assets to Master Fund.

FACTS

According to the information submitted, Master Fund, Contributing Fund 1, and Contributing Fund 2 are series of registered investment companies sponsored by Manager.

Master Fund was formed on Date 1 and began operations on Date 2. It is a series of Trust 1, an open-end management investment company organized under State 1 law that is registered under the Investment Company Act of 1940 (the 1940 Act) with the Securities and Exchange Commission (the SEC). The governing document of Trust 1 provides that the beneficial interests in the Trust property shall consist of non-transferable interests. Interests may be sold only to Institutional Investors defined as any regulated investment company, segregated asset account, foreign investment company, common trust fund, group trust or other investment arrangement, within or without the United States of America, other than an individual, S corporation, partnership or grantor trust beneficially owned by any individual, S corporation or partnership.

Master Fund is a separate and distinct subtrust of Trust 1, and no other subtrust of Trust 1 will have an interest in the assets belonging to Master Fund. Further, no investor in Master Trust shall have any right or interest in the assets belonging to any subtrust of Trust 1 in which it does not hold an interest. Similarly, no subtrust shall be liable for or charged with the liabilities belonging to any other subtrust, and no investor shall be subject to any liabilities belonging to any subtrust in which it does not hold an interest.

The interest of an investor in Master Fund will be determined by reference to its capital and distribution accounts, without regard to its capital account in any other subtrust. A separate book capital account and a separate tax capital account shall be maintained for each investor. The governing document of Trust 1 provides that the maintenance of book capital and tax capital accounts are intended to comply with § 1.704-1(b) of the Income Tax Regulations, and shall be interpreted and applied in a manner consistent with such regulations.

It is represented that each subtrust, including Master Fund, invests its assets so as to comply with the requirements of subchapter M of the Internal Revenue Code as though they were applied at the subtrust level, including meeting the diversification requirements of § 851(b)(3) of the Internal Revenue Code at the close of each quarter of the tax year of any investor that elects to be treated as a regulated investment company (RIC).

Contributing Fund 1 is a series, within the meaning of § 851(g), of Trust 2, a State 2 business trust. Contributing Fund 1 has elected to be treated as a RIC within the meaning of § 851. Contributing Fund 1 commenced operations on Date 3.

Contributing Fund 2 is a subtrust of Trust 3. Like Trust 1, Trust 3 is an open-end management investment company organized under State 1 law and registered under the 1940 Act. Contributing Fund 2, which was established Date 4 and commenced operations on Date 5, is also a master fund to a number of feeder funds. Contributing Fund 2 has substantially the same investment objectives as Master Fund.

On Date 2, Contributing Fund 1 contributed all of its assets to Master Fund (the Contributing Fund 1 Contribution). The purpose of this contribution was to establish a master-feeder investment structure with Contributing Fund 1 as a feeder fund and Master Fund as a master fund. Prior to Date 2, Master Fund did not contain any assets. On Date 6, Contributing Fund 2 contributed all of its assets to Master Fund (the Contributing Fund 2 Contribution) and thereafter liquidated, distributing the interests in Master Fund it received to its feeder funds in complete redemption of the interests in it held by those funds. The purpose of this contribution was to consolidate the assets of what were two master funds with substantially similar investment objectives into a single master fund.

The following additional representations are made:

- Master Fund represents that it has had at least two members from the date of its receipt of the initial investment made by any investor, and that it has not elected and will not elect pursuant to § 301.7701-3 of the Procedure and Administration regulations to be treated other than as a partnership for federal tax purposes.

- Master Fund represents that it has not and will not have more than 100 partners, counting as partners for this purpose any partner in any partnership investing in Master Fund. Trust 1 and Master Fund further represent that no interests in Master Fund have been or will be traded on an established securities market or issued in a transaction registered under the Securities Act of 1933.

- The Funds represent that (a) not more than 25 percent of the value of the total assets of each Fund is invested in the stock and securities of any one issuer, and (b) not more than 50 percent of the value of the total assets of each Fund is invested in the stock and securities of five or fewer issuers. For purposes of making this representation: (I) all members of a controlled group of corporations (as defined in § 1563(a)) shall be treated as one issuer, and (II) in determining total assets, each Fund has excluded cash. Government securities are included in the total assets for purposes of the denominator of the 25 and 50-percent tests (unless acquired to meet the 25 percent 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. Further, all Funds holding stock in regulated investment companies, real estate investment trusts or investment companies which meet the requirements of (a) and (b), shall be considered as holding a proportionate share of the assets held by such companies or trusts.

- Contributing Fund 1 and Contributing Fund 2 represent that they each transferred a diversified portfolio of assets to Master Fund in satisfaction of the diversification test of § 368(a)(2)(F)(ii). For purposes of the preceding sentence, the principles of § 368(a)(2)(F) apply, except that Government securities are not excluded for purposes of determining total assets under § 368(a)(2)(F)(iv), unless the Government securities are acquired to meet § 368(a)(2)(F)(ii).

- The Funds represent that none of the investors in Master Fund or Contributing Fund 2 acquired their interests in either Master Fund or Contributing Fund 2 in exchange for any asset other than cash or other permissible investments of “investment partnerships” within the meaning of § 731(c)(3)(C)(i).

Master Fund further represents that:

- Except as required by § 704(c) and the regulations thereunder, each investor's allocable share of Master Fund's income will be composed of a proportionate share of each item of income includible in Master Fund's gross income. Allocations of taxable income, gain, loss and deduction will conform to §§ 704(b) and (c) and the regulations thereunder.

- Except as required by § 704(c) and § 1.704-1(b), allocations of specific items of income, gain, loss, deduction, and credit will be proportionate to the interest of each investor in Master Fund;

- Master Fund was not organized in a manner to enable it to be classified as a partnership under § 301.7701-2 for the purpose of enabling any investor that is a RIC to make distributions that would otherwise be prohibited under Rev. Rul. 89-81, 1989-1 C.B. 226, had the RIC invested directly in Master Fund's assets;

- Each investor of Master Fund that is a RIC will, for purposes of determining the required distribution under § 4982(a)(1), account for its share of partnership items of income, gain, loss, and deduction as the items are taken into account by Master Fund, as required by Rev. Rul. 94-40, 1994-1 C.B. 274.

LAW AND ANALYSIS

Section 301.7701-4(a) provides that in general, the term "trust" refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purposes of protecting or conserving it for the beneficiaries. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Section 301.7701-4(c)(1) provides that an “investment” trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. See Commissioner v. North American Bond Trust, 122 F. 2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942).

Section 301.7701-2(a) provides that for purposes of §§ 301.7701-2 and 301.7701-3, a "business entity" is any entity recognized for federal tax purposes that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an *eligible entity*) can elect its classification for federal tax purposes. Section 301.7701-2(b) generally provides that business entities that are classified as corporations for federal tax purposes include corporations denominated as such under applicable law, as well as associations, joint-stock companies, insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, organizations that are taxable as corporations under a provision of the Code other than § 7701(a)(3) (which generally defines corporations), and certain organizations formed under the laws of a foreign jurisdiction (including a U.S. possession, territory or commonwealth). Master Fund is not a per se corporation under § 301.7701-2(b).

Under § 301.7701-3(b)(1)(i), a domestic eligible entity is a partnership if it has two or more members, unless it elects otherwise.

In National Securities Series – Industrial Stock Series et. al. v. Commissioner, 13 T.C. 884 (1949), acq. 1950-1 C.B. 4, the U.S. Tax Court recognized that the several series of a single investment trust may be considered distinct taxable entities, each a separate regulated investment company. Although the classification of the entities in that case was not in issue, the court assumed in its opinion that each of the several series created under a single trust instrument was a separate taxpayer. Rev. Rul. 55-416, 1955-1 C.B. 416, cites National Securities Series with approval and repeats the Tax Court's tacit characterization of the series funds as separate taxpayers. Thus, a trust consisting of separate series can be classified as multiple taxpayers.

Master Fund represents that it has had at least two investors since the date of its receipt of the initial investment made by any investor and that it will not file an entity classification election to be taxed as other than a partnership. Accordingly, Master Fund will be a separate taxable entity taxed as a partnership for federal income tax purposes.

Section 7704(a) provides that a publicly traded partnership is treated as a corporation. Section 7704(b) and § 1.7704-1(a) provide that, under § 7704, the term "publicly traded partnership" means any partnership if interests in the partnership are (i) traded on an established securities market, or (ii) readily tradable on a secondary market or the substantial equivalent thereof.

Section 1.7704-1(c)(1) provides that interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable economically to trading on an established securities market.

Section 1.7704-1(h)(1) provides that interests in a partnership are not treated as readily tradable on a secondary market or the substantial equivalent thereof within the meaning of § 7704(b) 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; and (ii) the partnership does not have more than 100 partners at any time during the taxable year of the partnership.

Section 1.7704-1(h)(3) provides that, for § 1.7704-1(h)(1), a person who owns an interest in a partnership, grantor trust, or S corporation (flow-through entities) that owns, directly or through other flow-through entities, an interest in the partnership is treated as a partner in the partnership only if (i) substantially all of the value of the beneficial owner's interest in the flow-through entity is attributable to the flow-through entity's interest (direct or indirect) in the partnership; and (ii) a principal purpose of the use of the tiered arrangement is to permit the partnership to satisfy the 100-partner limitation of § 1.7704-1(h)(1)(ii).

None of the interests in Master Fund were issued in a transaction that was registered under the Securities Act of 1933. Furthermore, the taxpayers represent that Master Fund has not and will not have more than 100 partners, and that only Institutional Investors will own interests in Master Fund. Therefore, we conclude that Master Fund is not a "publicly traded partnership" under § 7704.

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in Chapter 1 of the Code, be determined by the partnership agreement.

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if– (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 1.704-1(b)(2)(ii)(h) provides that the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement.

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 if 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, generally, that an allocation has economic effect if, throughout the full term of the partnership, the partnership agreement provides that (1) the partners' capital accounts will be maintained in accordance with § 1.704-1(b)(2)(iv), (2) upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions will be made to the partners in accordance with their positive capital account balances, and (3) partners are unconditionally required to restore the negative balance of their capital accounts to the partnership upon the liquidation of their interests in the partnership.

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 the partner to the partnership, (2) the fair market value of property contributed by the partner 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 the partner of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in § 1.704-1(b)(2)(iv)(g), but excluding income and gain described in § 1.704-1(b)(4)(i); and decreased by (4) the amount of money distributed to the partner by the partnership, (5) the fair market value of property distributed to the partner by the partnership (net of liabilities secured by such distributed property that such partner is considered to assume or take subject to under § 752), (6) allocations to the partner of expenditures of the partnership described in § 705(a)(2)(B), and (7) allocations of partnership loss and deduction (or items thereof), including loss and deduction described in § 1.704-1(b)(2)(iv)(g), but excluding items described in (6) above and loss or deduction described in § 1.704-1(b)(4)(i) or (iii).

The Trust 1 governing document provides that the book capital account balance of each investor shall be adjusted each day by the following amounts: (a) increased by any increase in net unrealized gains or decrease in net unrealized losses allocated to such investor; (b) decreased by any decrease in net unrealized gains or increase in net unrealized loses allocated to such investor; (c) increased or decreased, as the case may be, by the amount of profit or loss, respectively, allocated to such investor; (d) increased by any capital contribution made by such investor; and (e) decreased by any distribution, including any distribution to effect a withdrawal or redemption, made to such investor by Trust 1.

It further provides that upon dissolution of Trust 1, the Trustees shall liquidate the assets of the Trust, apply and distribute the proceeds in accordance with the investors' positive book capital account balances in accordance with the requirements described in Treasury Regulations § 1.704-1(b)(2)(ii)(b)(2). If an investor has a negative balance in its book capital account following the liquidation of its Interest, as determined after taking into account all capital account adjustments for the fiscal year during which the liquidation occurs, then such investor shall restore the amount of such negative balance to the Trust so as to comply with the requirements of Treasury Regulations § 1.704-1(b)(2)(ii)(b)(3). Such amount shall, upon liquidation of the Trust be paid to creditors of the Trust or distributed to other investors in accordance with their positive book capital account balances.

After review of the submitted documents, and based on the representations made, we conclude that the allocations provided for in the Trust 1 governing document meet the requirements for economic effect set forth in § 1.704-1(b)(2)(ii)(b). Accordingly, the allocations of profits and losses contained in the Trust 1 governing document have economic effect within the meaning of § 704(b). No opinion is expressed or implied regarding whether the allocations of profits and losses contained in the Trust 1 governing document satisfy the requirements for substantiality as set forth in § 1.704-1(b)(2)(iii).

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) states that the purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution 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 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). 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 property 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)(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 SEC as a management company under the Investment Company Act of 1940.

Master Fund is registered with the SEC as a management company under the 1940 Act, and pursuant to the Trust 1 governing documents, makes all of its book allocations in proportion to the partners' relative book capital accounts. Therefore, Master Fund is a securities partnership for purposes of § 1.704-3(e)(3).

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).

Section 1.704-3(e)(3)(i) identifies the partial netting approach for aggregating reverse § 704(c) gains as generally reasonable. Under § 1.704-3(e)(3)(iv), to use the partial netting approach, the partnership must establish appropriate accounts for each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses. Under the partial netting approach, on the date of each capital account restatement, the partnership: (A) nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners; (B) separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and (C) separately allocates the aggregate tax gain and aggregate tax loss to its partners in a manner that reduces the disparity between the book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

Under the Trust 1 governing documents, all net realized gain or loss from transactions in qualified financial assets (within the meaning of § 1.704-3(e)(3)(ii)) shall be aggregated separately (as between gains and losses) and as aggregated shall be allocated as follows:

> (i) Net realized gain shall be allocated among all investors whose respective Book Capital Account balances exceed their respective tax capital account balances to the extent of such excesses (or in proportion thereto, if the total amount to be allocated is less);
>
> (ii) Any net realized gains remaining after the allocations thereof pursuant to subparagraph (i) shall be allocated pro rata among the investors in proportion to their then respective book capital account balances;
>
> (iii) Net realized loss shall be allocated among all investors whose respective tax capital account balances exceed their respective book capital account balances to the extent of such excesses (or in proportion thereto, if the total amount to be allocated is less);
>
> (iv) Any net realized losses remaining after the allocations thereof pursuant to subparagraph (iii) shall be allocated pro rata among the investors in proportion to their then respective book capital account balances;

The documents provide that the foregoing allocation rules are intended to reflect a partial netting approach of making reverse § 704(c) allocations on an aggregate basis within the meaning of § 1.704-3(e)(3)(iv) and shall be construed consistently therewith. Allocations of capital gain and loss will be pro rata from net short-term capital gain or loss and net long-term capital gain or loss, and otherwise shall conform with the

requirements of § 1.704-3(e)(3)(vi)(A); the Trust shall keep all records necessary or appropriate to give effect to the foregoing.

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.

Based on the facts presented and the representations made, we conclude that Master Fund will be allowed to make reverse § 704(c) allocations on an aggregate basis. Furthermore, we conclude that the approach used by Master Fund to aggregate gains and losses from qualified financial assets is a reasonable approach that is consistent with the purpose of § 704(c). This ruling only applies to reverse § 704(c) allocations. We express no opinion concerning the aggregation of "forward" § 704(c) allocations by any of the Funds. Aggregation of built-in-gains and losses from contributed property is only permitted pursuant to published guidance or by letter ruling (see § 1.704-3(e)(4)(iii) and Rev. Proc. 2001-36, 2001-36 I.R.B. 1, in which the Service granted automatic permission for certain securities partnerships to aggregate contributed property for purposes of making § 704 (c) allocations.)

Section 721(a) provides that no gain or loss shall be recognized by 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(a) provides 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 or securities in such corporation and immediately after the exchange the transferors are in control (as defined in § 368(c)) of the corporation. Section 351(e)(1) provides that § 351 will not apply to transfers of property to an investment company. Under § 1.351-1(c)(1), a transfer of property after June 30, 1967, will be considered to be a transfer to an investment company if (i) the transfer results, directly or indirectly, in diversification of the transferors' interests, and (ii) the transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts. Section 1.351-1(c)(2) provides that the determination of whether a corporation is an investment company is ordinarily made by reference to the circumstances in existence immediately after the transfer in question. However, § 1.351-1(c)(2) also provides that where circumstances change thereafter pursuant to a plan in existence at the time of the transfer, this determination shall be made by reference to the later circumstances.

Section 1.351-1(c)(5) provides that a transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets 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 stock and securities will not be treated as resulting in diversification of the transferors' interests if each transferor transfers a diversified portfolio of stock and securities, and (ii) a portfolio of stock 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 the total assets for purposes of the denominator of the 25 and 50-percent tests (unless acquired to meet the 25 percent 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 portfolio 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 five or fewer issuers.

Contributing Fund 1 had a diversified portfolio immediately before the Contributing Fund 1 Contribution and Master Fund had a diversified portfolio immediately after the Contributing Fund 1 Contribution. Additionally, Contributing Fund 2 and Master Trust each had a diversified portfolio immediately before the Contributing Fund 2 Contribution and Master Trust had a diversified portfolio immediately after the Contributing Fund 2 Contribution. As a result, the transfers of the diversified assets by Contributing Fund 1 and Contributing Fund 2 to Master Fund will not be a transfer to an investment company within the meaning of § 351(e)(1), and consequently § 721(b) will not prevent the nonrecognition provision of § 721(a) from applying to those transfers nor cause any realized gain to be recognized.

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 increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

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 increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Accordingly, Contributing Fund 1 will have a basis in its interest in Master Fund, equal to the amount of money and aggregate adjusted bases of the property it contributed to Master Fund. Master Fund will have a basis in any property contributed to it by Contributing Fund 1 equal to the adjusted basis of such property to Contributing Fund 1 at the time of the contribution.

Similarly, Contributing Fund 2 will have a basis in its interest in Master Fund, equal to the amount of money and aggregate adjusted bases of the property it contributed to Master Fund. Master Fund will have a basis in any property contributed to it by Contributing Fund 2 equal to the adjusted basis of such property to Contributing Fund 2 at the time of the contribution.

Section 1223(2) provides that in determining the period for which a taxpayer has held property, however acquired, there shall be included the period for which such property was held by any other person, if such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part to the taxpayer as it would have to such other person.

The holding period of Master Fund in any capital asset received in the contribution from Contributing Fund 1 will include Contributing Fund 1's holding period of such property. The holding period of Master Fund in any capital asset received in the contribution from Contributing Fund 2 will include Contributing Fund 2's holding period of such property.

Section 731(a) provides that in the case of a distribution by a partnership to a partner, (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution; and (2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in § 731(a)(2)(A) or (B) is distributed to such partner, loss will be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of -- (A) any money distributed, and (B) the basis to the distributee, as determined under § 732, of any unrealized receivables (as defined in § 751(c)) and inventory (as defined in § 751(d)).

Section 731(c)(1) provides that for purposes of §§ 731(a)(1) and 737, the term "money" includes marketable securities, and such securities shall be taken into account at their fair market value as of the date of the distribution.

Section 731(c)(2)(A) provides that for the purposes of § 731(c) the term "marketable securities" means financial instruments and foreign currencies which are, as of the date of the distribution, actively traded (within the meaning of § 1092(d)(1)).

Section 731(c)(2)(B)(iii) provides that for the purposes of § 731(c) the term "marketable securities" includes any financial instrument the value of which is determined substantially by reference to marketable securities.

Section 731(c)(2)(B)(v) provides that, except as otherwise provided in regulations, the term “marketable securities” includes interest in an entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both. Section 731(c)(2)(B)(vi) provides that, to the extent provided in regulations, such term includes any interest in an entity not described in § 731(c)(2)(B)(v) but only to the extent of the value of such interest which is attributable to marketable securities, money or both.

Section 1.731-2(c)(3)(i) of the regulations provides that, for purposes of § 731(c)(2)(B)(v), substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entiy (by value) at the time of distribution of an interest in the entiy consist (directly or indirectly) of marketable securities, money, or both. Section 1.731-2(c)(3)(ii) provides that, for puposes of § 731(c)(2)(B)(vi), an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

Section 731(c)(2)(C) provides that the term "financial instrument" includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives.

Section 731(c)(3)(A)(iii) provides that § 731(c)(1) shall not apply to the distribution from a partnership of a marketable security to a partner if such partnership is an investment partnership and such partner is an eligible partner thereof.

Section 731(c)(3)(C)(i) provides that the term "investment partnership" means any partnership which has never been engaged in a trade or business and substantially all of the assets (by value) of which have always consisted of (I) money, (II) stock in a corporation, (III) notes, bonds, debentures, or other evidences of indebtedness, (IV) interest rate, currency, or equity notional principal contracts, (V) foreign currencies, (VI) interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described in any other subclause of this clause or in any commodity traded on or subject to the rules of a board of trade or commodity exchange, (VII) other assets specified in regulations prescribed by the Secretary, or (VIII) any combination of the foregoing.

Section 731(c)(3)(C)(ii) provides that a partnership shall not be treated as engaged in a trade or business by reason of (I) any activity undertaken as an investor, trader, or dealer in any asset described in § 731(c)(3)(C)(i), or (II) any other activity

specified in regulations prescribed by the Secretary.

Section 731(c)(3)(C)(iii) provides that the term "eligible partner" means any partner who, before the date of the distribution, did not contribute to the partnership any property other than assets described in § 731(c)(3)(C)(i).

The Funds represent that none of the investors in Master Fund or Contributing Fund 2 acquired their interests in either Master Fund or Contributing Fund 2 in exchange for any asset other than cash or other permissible investments of "investment partnerships" within the meaning of § 731(c)(3)(C)(i).

Section 751(c) provides that for the purposes of subchapter K, the term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for - (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered or to be rendered.

Section 751(d) provides that for the purposes of subchapter K, the term "inventory" means -- (1) property of the partnership of the kind described in § 1221(a)(1), (2) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in § 1231, (3) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under § 1246(a) (relating to gain on foreign investment company stock), and (4) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in § 751(d)(1), (2), or (3).

After applying the relevant law to the facts submitted and the representations made, we conclude that the Contributing Fund 2 contribution along with the related distributions, involved the distribution of property from "investment partnerships" to "eligible partners," as those terms are used in § 731(c)(3)(A)(iii). Therefore, no investor in Master Fund or Contributing Fund 2 shall recognize any gain or loss in connection with the issuance of interests in Master Fund in exchange for and in liquidation of interests in Contributing Fund 2.

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

Section 735(b) provides that in determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of § 735(a)(2)), there shall be included the holding period of the partnership, as determined under § 1223, with respect to such property.

Section 1223(2) provides that in determining the period for which a taxpayer has held property, however acquired, there shall be included the period for which such property was held by any other person, if such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part to the taxpayer as it would have to such other person.

Each investor in Contributing Fund 2 receiving an interest in Master Fund will have a basis in such interest in Master Fund equal to its adjusted basis in Contributing Fund 2 and the holding period of such interest will include Contributing Fund 2's holding period, as determined under § 1223, for such interest.

Section 851(b) 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) 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 its business of investing in such stocks, securities, or currencies.

Section 851(b)(3)(A) 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) 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) provides with respect to a partnership 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) that states that income derived from a partnership or trust shall be treated as satisfying the 90 percent requirement 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 includible 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, 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., 2nd Sess. 59 (1954).

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

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 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). 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) 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 feeder funds. 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) 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 the partner's 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.

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 conclude that Contributing Fund 1 (assuming it qualifies as a RIC) will be deemed to own a proportionate share of the assets of Master Fund and will be deemed to be entitled to the income of Master Fund attributable to that share for purposes of determining whether Contributing Fund 1 satisfies the requirements of § 851(b)(2) and § 851(b)(3). For purposes of these sections, the interest of Contributing Fund 1 in Master Fund shall be determined in accordance with Contributing Fund 1's capital interest in Master Fund. No ruling or opinion is given with respect to any investment made in Master Fund by Contributing Fund 2 as Contributing Fund 2 is thereafter liquidated. Further, no ruling is given with respect to any other RIC that may be an investor in Master Fund or any other investor that is not a party to this ruling request. Finally, no opinion is given whether Contributing Fund 1 or any other party to this ruling request qualifies as a RIC for federal tax purposes.

Except as specifically ruled upon above, we express no opinion on the federal tax consequences of the transactions described above under any other provisions of the Code.

Pursuant to a power of attorney on file with this office, a copy of this letter will be sent to your authorized representative.

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

Sincerely yours,

/s/

Donna Marie Young
Acting Chief, Branch 3
Office of the Associate Chief Counsel
Passthroughs and Special Industries

Enclosures:
Copy of this letter
Copy for § 6110 purposes