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Date:

July 29, 2003

### LEGEND:

Master Fund =

Feeder Fund =

Advisors =

State A =

State B =

State C =

Dear :

This responds to your request for rulings dated January 15, 2003, submitted by your authorized representative on behalf of the Master Fund and the Feeder Fund. The rulings requested are as follows:

1. The Feeder Fund will be deemed to own a proportionate share of each asset of the Master Fund and will be deemed to be entitled to the income of the Master Fund attributable to its interest for purposes of determining whether it satisfies the requirements of sections 851(b)(2), 851(b)(3), 852(b)(5), 853, and 854 of the Internal Revenue Code of 1986.
2. The Master Fund will not be a publicly traded partnership taxed as a corporation under section 7704.
3. No gain or loss will be recognized by the Master Fund or Feeder Fund upon a contribution of property to the Master Fund by the Feeder Fund solely in exchange for shares of beneficial interest in the Master Fund and the Master Fund's assumption of liabilities, if any.

4. The Feeder Fund's basis in the shares of beneficial interest received in the Master Fund will equal the basis of the assets transferred in exchange therefor, reduced by the sum of the Feeder Fund's liabilities assumed by the Master Fund or liabilities to which the assets transferred were subject.
5. The Feeder Fund's holding period in shares of beneficial interest received in the Master Fund will include the period during which the property exchanged was held by the Feeder Fund, provided that the property constitutes a capital asset as defined in section 1221 or property described in section 1231 on the date of the exchange.
6. The Master Fund's basis in the assets received from the Feeder Fund will equal the basis of the property in the hands of the Feeder Fund before the exchange.
7. The Master Fund's holding period in the assets received from the Feeder Fund will include the period during which the Feeder Fund held the assets.

## FACTS

The Master Fund is a business trust established in accordance with the laws of State A. The Master Fund registered with the Securities and Exchange Commission (SEC) as an open-end management company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. (the "1940 Act").

The Feeder Fund is organized as a corporation under the laws of State B. The Feeder Fund has elected and qualified to be taxed as a regulated investment company (RIC) under Part I of subchapter M since inception and intends to continue to so qualify.

Advisors are the principal investment advisors of the Master Fund. The Feeder Fund is not charged an investment advisory fee.

The Master Fund serves as an investment vehicle for the Feeder Fund having identical investment objectives. The Feeder Fund will contribute substantially all its assets, which consist of a diversified portfolio of stocks, securities, and cash, to the Master Fund in exchange for an interest therein. The assets of the Feeder Fund will be managed by the Master Fund.

The Master Fund represents as follows:

1. The Feeder Fund will contribute to the Master Fund solely assets that will constitute a diversified portfolio of stock and securities as defined in section 1.351-1(c)(6)(i) in exchange for an interest therein. The Master Fund will require that any future feeder fund contribute solely cash and/or a portfolio of assets that meets the diversification requirements of section 1.351-1(c)(6)(i).

2. Other than certain enumerated holdings disclosed to the Internal Revenue Service, the taxpayers are not aware of any holdings by the Feeder Fund that are members of a controlled group of corporations within the meaning of section 368(a)(2)(F)(ii).
3. The adjusted basis and the fair market value of the assets of the Feeder Fund to be exchanged for interests in the Master Fund will equal or exceed the sum of the liabilities to be assumed by the Master Fund (if any) plus any liabilities to which the transferred assets are subject.
4. The Feeder Fund will receive shares of beneficial interest in the Master Funds approximately equal to the fair market value of the assets transferred to the Master Fund.
5. The Master Fund is organized in a manner so as to enable its classification as a partnership and not to enable investors which 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 the Master Fund.
6. For purposes of determining its required distribution under section 4982(a), the Feeder Fund will account for its share of items of income, gain, loss and deduction of the Master Fund as they are taken into account by the Master Fund.
7. The Master Fund will be limited to 100 or fewer members and no partnership, grantor trust, or S Corporation described in section 301.7701-1(h)(3) will become a holder in the Master Fund. No interests in the Master Fund are traded on an established securities market or issued in a transaction under the 1933 Act, because the interests in the Master Fund are required to be registered under the 1933 Act (private placement exception).

#### LAW AND ANALYSIS

**Ruling Request 1: The Feeder Fund will be deemed to own a proportionate share of each asset of the Master Fund and will be deemed to be entitled to the income of the Master Fund attributable to its interest for purposes of determining whether it satisfies the requirements of sections 851(b)(2), 851(b)(3), 852(b)(5), 853, and 854.**

Section 851(b) provides that certain requirements must be satisfied in order for a domestic corporation to be taxed as a RIC.

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 section 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 value 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 852(b)(5) provides that a RIC at least 50 percent of the value (as defined in section 851(c)(4)) of whose total assets at the close of each calendar quarter consists of obligations described in section 103(a) is eligible to pay exempt-interest dividends.

Section 853(a) provides that a RIC more than 50 percent of the value (as defined in section 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 section 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 tax credit under section 901.

Section 854(b)(1)(A) provides that a dividend, other than a capital gain dividend, received from a RIC qualifies for the dividends received deduction under section 243(a) to the extent so designated by the RIC provided that the RIC meets the requirements of section 852(a) for the taxable year during which it paid the dividend.

Section 854(b)(1)(B) provides that the aggregate amount that may be designated as dividends under section 854(b)(1)(A) shall not exceed the aggregate dividends received by the RIC for the taxable year.

Section 854(b)(3)(A) provides that the term "aggregate dividends received" includes only dividends received from domestic corporations.

Section 854(b)(4) provides, in part, that for purposes of determining an amount to be treated as a dividend eligible for the dividends received deduction under section 243 a payment to a RIC shall not be treated as a dividend unless, had it not been a RIC, it would have been allowed a dividends received deduction under section 243 with respect to the payment.

Section 702(b) provides with respect to a partnership that the character of items stated in section 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 section 851(b) that states that income derived from a partnership or trust shall be treated as satisfying the 90 percent requirement of section 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 section 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 section 702 to the 90 percent test under section 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., 2d Sess. 59 (1954).

In order for the Feeder Fund to qualify as a RIC under the diversification tests of section 851, the aggregate approach will have to be applied to the Feeder Fund's partnership interest in the Master Fund. As an aggregate, the 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, section 805(b) required life insurance companies to value their assets each taxable year. For this purpose, section 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 was whether, for purposes of section 805(b)(4), the life insurance company's interest in the partnership was 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 section 805(b)(4). The ruling cites sections 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 section 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 section 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 holders. The flush language of section 851(b) mandates an aggregate approach in applying the 90 percent gross income test of section 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 section 851(b)(2) test but not be viewed as a direct investment in those assets for purposes of the test set out in section 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 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 section 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 rule that the Feeder Fund, assuming it qualifies as a RIC and is a partner in the Master 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 sections 851(b)(2), 851(b)(3), 853(a), and 854 and section 1.1092(b)-2T. For purposes of these sections, the interests 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 Request 2: The Master Fund will not be a publicly traded partnership taxed as a corporation under section 7704.**

Section 7704(a) provides that a publicly traded partnership is treated as a corporation. Section 7704(b) and section 1.7704-1(a) provide that, for purposes of section 7704, the term "publicly traded partnership" means any partnership if interests in the partnership are: (1) traded on an established securities market; or (2) readily tradable on a secondary market or the substantial equivalent thereof.

Under § 1.7704-1(b) the term established securities market includes (1) a national securities exchange registered under section 6 of the Securities and Exchange Act of 1933 (The 1933 Act), (2) a national securities exchange exempt from registration under the 1933 Act, (3) a foreign securities exchange that satisfies the requirements analogous to the requirements under the 1933 Act, (4) a regional or local exchange, and (5) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers.

Generally, under 1.7704-1(c)(1) interests are traded 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 readily tradable on a secondary market or the substantial equivalent thereof for purposes of section 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 1933 Act; 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 purposes of section 1.7704-1(h)(1), a person owning an interest in a partnership, grantor trust, or S corporation (flow-through entity) 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 section 1.7704-1(h)(1)(ii).

The Master Fund has represented that the number of partners in the Master Fund will be limited to 100 or fewer calculated pursuant to section 1.7704-1(h). No interest in the Master Fund has been or will be issued in a transaction (or transactions) required to be registered under the 1933 Act.

Accordingly, we rule that the Master Fund will not be a "publicly traded partnership" within the meaning of section 7704(b).

**Ruling Request 3: No gain or loss will be recognized by the Master Fund or a Feeder Fund upon a contribution of property to the Master Fund by the Feeder Fund solely in exchange for shares of beneficial interest in the Master Fund and the Master Fund's assumption of liabilities, if any.**

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 section 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 section 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 section 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 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 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 section 368(a)(2)(F)(ii), applying the relevant provisions of section 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 section 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.

Based on the applicable law, the facts submitted and representations made, we rule that the transfers by the Feeder Fund to the Master Fund are not transfers of property to a partnership that would be treated as an investment company (within the meaning of section 351) if the Master Fund was incorporated, provided that these are the only transfers to the Master Fund (except for transfers solely of cash and/or a diversified portfolio of stocks and securities, within the meaning of section 1.351-1(c)(6)(i)).

Contributions solely of cash and/or a diversified portfolio of stocks and securities (within the meaning of section 1.351-1(c)(6)(i)) to the Master Fund by the Feeder Funds will not cause any of the transfers described above to be treated as a transfer of property to a partnership (*i.e.*, the Master Fund) that would be treated as an investment company within the meaning of section 351 if the partnership were incorporated.

**Ruling Request 4: The Feeder Fund's basis in the shares of beneficial interest received in the Master Fund will equal the basis of the assets transferred in exchange therefor, reduced by the sum of the Feeder Fund's liabilities assumed by the Master Fund or liabilities to which the assets transferred were subject.**

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 section 721(b) to the contributing partner.

The Feeder Fund's basis in its interest in the Master Fund received in the transaction will equal the basis of the assets exchanged by the Feeder Fund for that interest, reduced by the sum of the Fund's liabilities assumed by the Master Fund to which the assets transferred were taken subject.

**Ruling Request 5: The Feeder Fund's holding period in shares of beneficial interest received in the Master Fund will include the period during which the property exchanged was held by the Feeder Fund, provided that the property constitutes a capital asset as defined in section 1221 or property described in section 1231 on the date of the exchange.**

Section 1223(1) provides that for purposes of determining the period for which a taxpayer has held property received in an exchange, there shall be included the period for which the taxpayer held the property exchanged if, under Chapter 1, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis, in whole or in part, as the property surrendered in the exchange, and the property exchanged was a capital asset as defined in section 1221 or property described in section 1231.

Section 1.1223-3(a) provides that a partner shall not have a divided holding period in an interest in a partnership unless the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods.

Section 1.1223-3(b)(1) provides the general rule that the portion of a partnership interest to which a holding period relates shall be determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).

The Feeder Fund's holding period in its interest in the Master Fund received in the transaction will include the period during which the property exchanged was held by the Feeder Fund, provided that such property was a capital asset or property described in sections 1221 or 1231 on the date of the exchange. Furthermore, pursuant to section 1.1223-3(a) and (b), to the extent the Feeder Fund transfers assets having different holding periods to the Master Fund, the Feeder Fund will have a divided holding period in the Master Fund interests received, with each portion determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates,

and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).

**Ruling Request 6: The Master Fund's basis in the assets received from the Feeder Fund will equal the basis of the property in the hands of the Feeder Fund before the exchange.**

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

The Master Fund's basis in the assets received from the Feeder Fund will equal the basis of such property in the hands of the Fund before the exchange.

**Ruling Request 7: The Master Fund's holding period in the assets received from the Feeder Fund will include the period during which the Feeder Fund held the assets.**

Section 1.723-1 provides that because property contributed to a partnership has the same basis in the hands of the partnership as it had in the hands of the contributing partner, the holding period of such property for the partnership includes the period during which it was held by the partner. See section 1.223(2).

The Master Fund's holding period in assets received from the Feeder Fund will, in each instance, include the period during which the Feeder Fund held such property.

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 and regulations or on the tax treatment of any conditions existing at the time of, or effects resulting from, any transaction(s) that are not specifically covered by the above rulings.

No opinion is expressed concerning whether the Feeder Fund qualifies as a RIC taxable under subchapter M, part I.

We express no opinion in Ruling Three as to whether the transactions described are part of a plan to achieve diversification without recognition of gain under section 1.351-1(c)(5). Furthermore, we express no opinion as to the consequences of other transfers to a Master Fund, either as to whether such other transfers would be "transfers to an investment company" or whether such other transfers would, when taken together, 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.

Temporary or 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 section 12.04 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1, 43 (January 6, 2003). However, if the criteria in section 12.06 of Rev. Proc. 2003-1 are satisfied, a ruling is not revoked or modified retroactively except in 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.

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

Sincerely yours,

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PATRICK E. WHITE  
Senior Counsel, Branch 1  
Office of Associate  
Chief Counsel  
(Financial Institutions & Products)

Enclosures:

Copy of this letter  
Copy for section 6110 purposes