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Washington, DC 20224

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CC:FIP:B02 – PLR-111808-03

Date:

September 30, 2003

**Legend:**

Fund =

Master Portfolio =

Advisor =

State =

Dear :

This responds to your request dated February 12, 2003, that the Internal Revenue Service rule (1) that Fund will be deemed to own a proportionate share of each asset of the Master Portfolio and will be deemed to be entitled to the income of the Master Portfolio attributable to its share for purposes of determining whether the Fund satisfies the requirements of §§ 851(b)(2), 851(b)(3), 852(b)(5), 853 and 854; and (2) that Master Portfolio is not a publicly traded partnership taxed as a corporation under section 7704.

## FACTS

Fund will operate as a series of a business trust established under the laws of State. It will qualify and elect to be taxed as a regulated investment company (RIC) under subchapter M, part 1 of the Internal Revenue Code of 1986.

Master Portfolio is also organized as a series of a business trust established under the laws of State. It is registered as an open-end management company under the Investment Company Act of 1940, 15 USC 80a-1, et seq., as amended (the "1940 Act"). It seeks to be classified as a partnership for federal tax purposes.

Fund and Master Portfolio are participants in a master-feeder structure. Fund is a Feeder Fund that contributes solely cash to Master Portfolio in exchange for shares of beneficial interest in Master Portfolio. Any future contributions by Fund to Master Portfolio in exchange for shares of beneficial interest in Master Portfolio will consist solely of cash. Other institutional investors (Feeder Funds) may contribute cash or assets to Master Portfolio in exchange for shares of beneficial interest. All holders of beneficial interest in Master Portfolio have qualified as and elected to be taxed as RICs.

Fund and Master Portfolio have an identical investment objective. Assets are managed at the Master Portfolio level. Advisor provides investment management and related services and is the principal investment advisor to Master Portfolio.

Fund guarantees its shareholders a minimum net asset value after a seven-year period by investing a fluctuating percentage of its assets in U.S. Treasury bonds and other fixed income investments. These investments, designed to protect the original principal value of the Fund, represent a significant percentage of Fund's assets. Accordingly, Fund believes that it does not invest "substantially all" of its assets in Master Portfolio as required by Rev. Proc. 2001-57, 2001-2 C.B. 577, and thus that the safe harbor set forth in that revenue procedure is not available. Fund therefore requests this ruling.

Fund represents the following:

1. Fund will contribute solely cash to Master Portfolio in exchange for shares of beneficial interest approximately equal in value to the contributed cash. At no time will Fund transfer assets other than cash to Master Portfolio.
2. The Master Portfolio has been 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. 226, had they invested directly in the securities held by the Master Portfolio.

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3. Master Portfolio will invest its assets so as to comply with the requirements of subchapter M, part 1, of the Code as if such requirements applied at the Master Portfolio level.
4. For purposes of determining its required distribution under §4982(a) of the Code, Fund will account for its share of items of income, gain, loss and deduction of Master Portfolio as they are taken into account by Master Portfolio.
5. Master Portfolio has not elected to be treated as a corporation under §301.7701-3 of the regulations.
6. Beneficial interests in the Master Portfolio are not traded on an established securities market as described in §1.7704-1(b).
7. Interests in Master Portfolio are not regularly quoted by any broker or dealer or market maker, nor are any quotations for bids or offers made available with respect to any interest in the Master Portfolio.
8. There are no means available for holders of beneficial interests in Master Portfolio to buy, sell or exchange their interest in Master Portfolio through public means in a manner comparable to trading on an established securities market.
9. All holders of beneficial interests in Master Portfolio have qualified and elected RIC status as described in §851 of the Code.
10. Master Portfolio does not have and will not have more than 100 partners, counting as partners for this purpose any partner in any partnership investing in Master Portfolio.
11. No interests in Master Portfolio have been or will be traded on an established securities market or issued in a transaction registered under the Securities Act of 1933 (the “1933 Act”).

## **LAW AND ANALYSIS**

**Ruling Request 1: Fund will be deemed to own a proportionate share of each asset of Master Portfolio and will be deemed to be entitled to the income of Master Portfolio attributable to its share 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 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 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 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% 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, which are treated by the RIC's shareholders as interest excludable from gross income pursuant to section 103(a).

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.

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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)(l) 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 Fund to qualify as a RIC under the diversification tests of section 851, the aggregate approach will have to be applied to Fund's partnership interest in a Master Partnership. As an aggregate, Fund will be entitled to take into account its share of the individual items of income and assets of the Master Partnership.

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

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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 is whether, for purposes of section 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 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.

Rev. Proc. 2001-57 sets forth conditions under which a RIC that holds a partnership interest is treated, for purposes of qualifying as a RIC under §851(b)(3), for purposes of the payment of exempt-interest dividends under §852(b)(5), and for purposes of the passthrough of the foreign tax credit under §853, as if directly invested in the assets held by the partnership. Under this revenue procedure, a publicly offered open-end RIC that invests substantially all its assets in one or more Master Partnerships that are registered as management companies under the 1940 Act, and (except as required by §1.704-3 of the regulations) whose allocable share of each item of the Master Partnership's income, gain, loss, deduction, and credit is proportionate to its percentage of ownership of the capital interests in the Master Partnership, is treated as if it directly invested in the assets held by the Master Partnership for the described purposes.

In a typical master-feeder structure described by Rev. Proc. 2001-57, a Feeder Fund invests substantially all its assets in an investment partnership ( a “Master Partnership”). Some Feeder Funds may invest in more than one Master Partnership. The requirement of section 3.03 of Rev. Proc. 2001-57 that a Feeder Fund invest substantially all its assets in one or more Master Partnerships (the “substantially all” requirement) is an anti-abuse provision intended as a safeguard against the selection of appreciated assets having a low basis in the hands of a Feeder Fund for contribution to a Master Partnership in exchange for shares of beneficial interest in the Master Partnership. Where, as here, a Feeder Fund contributes solely cash to a Master Partnership, this risk is not present.

**Ruling Request 2: Master Portfolio is not 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 §1.7704-1(a) of the regulations 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.

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, in general, 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.

Section 1.7704-1(h)(3) provides that, for purposes of §1.7704-1(h)(1) of the regulations, 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 §1.7704- 1(h)(1)(ii).



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

## **RULINGS**

### **Ruling Request 1:**

Based on the information and representations submitted, we rule that Fund, assuming it qualifies as a RIC and is a partner in Master Portfolio, will be deemed to own a proportionate share of each asset of Master Portfolio and will be deemed to be entitled to the income of Master Portfolio attributable to that share for purposes of determining whether it satisfies the requirements of section 851(b)(2), 851(b)(3), 852(b)(5), 853(a), and 854 of the Code. For purposes of these sections, Fund's interest in Master Portfolio shall be determined in accordance with its capital interest in Master Portfolio.

### **Ruling Request 2:**

We rule that Master Portfolio will not be a "publicly traded partnership" within the meaning of section 7704(b) of the Code.

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.

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

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 Fund for every taxable year in which it participates in the master-feeder arrangement described in this letter.

Sincerely,

William E. Coppersmith  
William E. Coppersmith

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Chief, Branch 2  
Office of Associate Chief Counsel  
(Financial Institutions & Products)