

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

January 6, 2000

Fund =

A =

D1 =

Trust =

State =

Dear :

This letter responds to your letter dated August 23, 1999, and subsequent correspondence submitted by you as an authorized representative of Fund, requesting certain rulings under § 704 of the Internal Revenue Code on behalf of Fund.

Specifically, you request rulings that: (i) the method of making reverse § 704(c) allocations by Fund (the partial-netting method) is a reasonable method within the meaning of § 1.704-3(e)(3) of the Income Tax Regulations and (ii) that Fund may combine built-in gains and losses from qualified financial assets contributed to it with gains and losses from revaluations for purposes of performing aggregate allocations.

A, the treasurer of Trust, represents the following facts: Fund is a separate series of Trust, a no-load, open-end management investment company organized as a business trust under the laws of State on D1. Fund will elect to be treated as a partnership for federal income tax purposes.

Fund will be a "master" in a "master-feeder" structure, in which each of the partners ("feeders") in Fund will invest 100

percent of its assets into Fund, where the assets will be managed in accordance with the established investment guidelines which mirror those of the feeder or feeders. The net investment income and realized and unrealized gains are then allocated to the feeders on a daily basis. This structure allows investment vehicles with the same investment objectives to pool their assets and be managed as a single portfolio thereby creating economies of scale while at the same time allowing each feeder to be marketed and distributed separately. Trust will act as investment adviser to Fund.

Eligible investors in Fund will be limited to regulated investment companies (as defined in § 851), institutional client separate accounts, § 401(k) plan assets, common or commingled trust funds, collective investment trusts, or similar organizations or entities that are "accredited investors" within the meaning of Regulation D under the Securities Act of 1933.

A further represents that the registration statement of Fund requires investments to be made either in cash or in securities acceptable to Trust. When an in-kind deposit of a designated portfolio of securities is transferred by a partner to Fund and such securities represent the partner's contribution to Fund, such securities will constitute a substantial replication, or a representation, of the stocks included in the index of Fund. In addition, Trust will be responsible for monitoring the in-kind securities contributions as to both the composition and the weighting of the component stocks represented in the index of Fund.

Fund proposes to use an aggregate method for making reverse § 704(c) allocations as described in § 1.704-1(b)(2)(iv)(f). Under this method, Fund will establish a revaluation account for each partner. The account reflects each partner's share of unrealized gains and losses of the partnership. Fund will daily determine the increase or decrease in its unrealized gains or losses and allocate either to its partners based on the relative values of their interests in Fund as of the beginning of that day. Net realized gain or loss will be allocated to partners based on their relative account balances in accordance with § 1.704-3(e)(3)(v) of the Income Tax Regulations.

Fund proposes to use the "partial netting approach" described in § 1.704-3(e)(3)(iv) for making § 704(c) and reverse § 704(c) allocations.

Allocations will be made without regard to: (i) whether the gain or loss was attributable to assets contributed by a partner or partners or (ii) what each partner's relative interest in the

appreciation or depreciation of a particular asset would be, if tracked, during the period that Fund held the asset.

A further represents that: (i) Fund will be registered as an open-end management company under the Investment Advisers Act of 1940 (1940 Act); (ii) substantially all of Fund's property will consist of readily tradable securities; (iii) allocations of taxable income, gain, loss, deduction, and credit will comply with the regulations promulgated under §§ 704(b) and 704(c); (iv) Fund will qualify as a "securities partnership" within the meaning of § 1.704-3(e)(3)(iii); and (v) Fund's revaluations and the corresponding allocations of tax items will not be made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partner's aggregate tax liability.

A further represents that Fund's burden of making § 704(c) allocations without the aggregation would be substantial. Each feeder will be making book-ups and book-downs on a daily basis.

A further represents that the formation of Fund and transfer of assets by the partners to Fund are not proposed, and will not be undertaken, with a view to shifting the tax consequences of built-in gain or loss in the contributed property among the partners.

Fund cannot try to benefit one feeder over another without violating its fiduciary obligation. As a registered investment company, Fund is subject to the fiduciary obligation of fair dealing with each partner under the 1940 Act and State fiduciary law.

Section 704(c)(1)(A) provides that 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 precontribution gain or loss. Under § 704(c), a partnership must allocate income, gain, loss, and deductions with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. This allocation must be made using any reasonable method that is consistent with the purpose of § 704(c).

Section 1.704-3(a)(6) provides that the principles of § 1.704-3 apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704-1(b)(2)(iv)(f) (reverse § 704(c) allocations). A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of §§ 704(b) and 704(c).

Section 1.704-3(a)(2) provides that § 704(c) generally applies on a property-by-property basis. Therefore, in determining whether there is a disparity between adjusted tax basis and fair market value, the built-in gains and built-in losses on items of contributed or revalued property generally cannot be aggregated.

Section 1.704-3(e)(3) sets forth a special rule allowing certain securities partnerships to make reverse § 704(c) allocations on an aggregate basis. Specifically, § 1.704-3(e)(3)(i) provides that, for purposes of making reverse § 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of § 704(c).

Section 1.704-3(e)(3)(i) provides, in part, 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). Sections 1.704-3(e)(3)(iv) and 1.704-3(e)(3)(v) describe approaches for aggregating reverse § 704(c) gains and losses that are generally reasonable.

Section 1.704-3(e)(3)(iv) describes the partial netting approach of making reverse § 704(c) allocations.

Section 1.704-3(e)(3)(iii)(A) defines a securities partnership as a partnership that is either a management company or an investment partnership, and that makes all of its book allocations in proportion to the partners' relative book capital accounts.

Section 1.704-3(e)(3)(ii) defines qualified financial assets as any personal property (including stock) that is actively traded, as defined in § 1.1092(d)-1 (defining actively traded personal property for purposes of the straddle rules).

The aggregate approaches described in § 1.704-3(e)(3) generally apply only to reverse § 704(c) allocations; thus, a securities partnership using an aggregate approach must generally account for any built-in gain or loss from contributed property separately. The preamble to § 1.704-3(e)(3) explains that the final regulations do not authorize aggregation of built-in gains or losses from contributed property with built-in gains or losses from revaluations because this type of aggregation can lead to substantial distortions in the character and timing of income and loss recognized by contributing partners. T.D. 8585, 1995-1 C.B. 120, 123. However, the preamble also recognizes that there may be instances in which the likelihood of character and timing distortions is minimal and the burden of making § 704(c) allocations separate from reverse § 704(c) allocations is great. Consequently, § 1.704-3(e)(4)(iii) authorizes the Commissioner to permit, by published guidance or by letter ruling, aggregation of qualified financial assets for purposes of making § 704(c) allocations in the same manner as that described in § 1.704-3(e)(3).

In this case, the burden of making § 704(c) allocations separate from reverse § 704(c) allocations is represented to be substantial. Each feeder will be making book-ups and book-downs on a daily basis. Unless the Commissioner permits Fund to aggregate § 704(c) gains and losses with reverse § 704(c) gains and losses, Fund will have to track pre-contribution unrealized gains and losses on a property-by-property basis, largely nullifying the benefits of the aggregate approach for making reverse § 704(c) allocations. Further, the similar tax characteristics of the feeders reduce the likelihood of abuse of an aggregate approach.

We conclude that Fund may aggregate built-in gains and losses from qualified financial assets contributed to Fund by the feeders with built-in gains and losses from revaluations of qualified financial assets held by Fund for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations. In addition, we conclude that Fund's method of making § 704(c)(1)(A) allocations and reverse § 704(c) allocations (the partial netting approach) is reasonable within the meaning of § 1.704-3(e)(3).

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, no opinion is expressed concerning the aggregation of built-in gains and losses from assets contributed to Fund except as detailed above. In addition, no opinion is expressed on the tax consequences of any partner's contribution of assets to Fund or on whether Fund is a publicly traded partnership.

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.

Pursuant to a power of attorney on file with this office, copies of this letter are being forwarded to Fund.

Sincerely yours,

J. THOMAS HINES  
Acting Branch Chief  
Branch 2  
Office of the Assistant  
Chief Counsel  
(Passthroughs and  
Special Industries)

Enclosures: 2  
Copy of a letter  
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