Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Legend

Portfolio	=
Trust	=
Fund	=
Company	=
Manager	=
State 1	=
State 2	=
Declaration	=
Date	=
$a	=
$b	=

This letter responds to your submission of April 28, 2000, together with subsequent correspondence, in which you requested certain rulings under §§ 704, 721, and 7704 of the Internal Revenue Code.

Facts

Portfolio is a sub-trust of Trust, which was organized as a business trust under the laws of State 1 pursuant to Declaration. Trust is registered as an investment company under the Investment Company Act of 1940 (1940 Act).

Portfolio is a separate business trust under the laws of State 1, which recognize that separate trusts established under a single instrument with common trustees are independent legal entities. Portfolio is registered as an investment company under the 1940 Act. Portfolio and Fund represent that Portfolio is classified as a partnership under § 301.7701-3(b)(1)(i) of the Procedure and Administration Regulations.

Portfolio serves as an investment vehicle for Fund. Fund is a separate series of Company, a State 2 corporation that is an open-end management investment company under the 1940 Act. Fund invests substantially all of its assets available for investment in Portfolio, and has the same investment objective as Portfolio. Fund is treated as a corporation for federal income tax purposes, and has elected (or will elect) to be taxed as a regulated investment company (RIC) under part I of subchapter M of chapter 1 of subtitle A of the Code. Fund intends to be operated in a manner which would permit it

to continue to qualify as a RIC.

Portfolio was formed on Date, when Manager became a partner in Portfolio in exchange for cash of $a, and Fund became a partner in Portfolio in exchange for securities and other assets with a fair market value of $b. Manager is the investment advisor for Fund.

Beneficial interests in Portfolio are issued solely in private placement transactions that do not involve any “public offering” within the meaning of section 4(2) of the Securities Act of 1933, as amended (1933 Act). Portfolio will not register its shares under the 1933 Act, because shares in Portfolio may be issued solely in private placement transactions that do not involve any “public offering” within the meaning of section 4(2) of the 1933 Act. Investments in Portfolio only may be made by investment companies or certain other entities that are “accredited investors” within the meaning of Regulation D under the 1933 Act. The interest of each partner in Portfolio is limited to the net assets of Portfolio and does not extend to the assets of any other investment vehicles of Trust. Portfolio has not invested in any of Trust’s other investment vehicles, nor are any of Trust’s other investment vehicles invested in Portfolio.

Except as required by § 704(c) and § 1.704-1(b)(4), each partner will be allocated a pro rata share of partnership income, gain, loss, deduction and credit in accordance with the regulations under § 704(b). Each partner’s initial capital account balance will be the amount of money and the fair market value of the property contributed to Portfolio by the partner. Under § 1.704-1(b)(2)(iv)(f), Portfolio will revalue its investment portfolio to fair market value as of the close of each day. Portfolio will adjust each partner’s capital account to reflect the partner’s share of the net change in the value of its portfolio of securities from the close of the prior day to the close of the current day. Portfolio intends to qualify as a securities partnership under § 1.704-3(e)(3)(iii).

The number of partners in Portfolio will be limited to 100 or fewer calculated pursuant to § 1.7704-1(h).

Portfolio has made the following additional representations:

(1) Fund has contributed either cash and/or a portfolio of assets that meets the diversification requirements of Treas. Reg. § 1.351-1(c)(6) as further defined in Section 368(a)(2)(F)(ii). For purposes of this test, Government securities are not included within the meaning of "securities" under section 368(a)(2)(F)(ii), but are included within the meaning of total "assets" in section 368(a)(2)(F)(iv).

(2) The assets contributed by Fund, other than cash, will consist of “readily marketable stock and securities” as defined in Treas. Reg. § 1.351-1(c)(3) prior to the Taxpayer Relief Act of 1997.

(3) All cash received by Portfolio will be invested in “readily marketable stock and

securities" as defined in Treas. Reg. § 1.351-1(c)(3) prior to the Taxpayer Relief Act of 1997.

(4) The burden of making § 704(c) allocations separate from reverse § 704(c) allocations is substantial.

Law and Analysis

Ruling # 1

Portfolio and Fund have requested a ruling that Portfolio will not be a "publicly traded partnership" within the meaning of § 7704(b).

Section 7704(a) provides that a publicly traded partnership is treated as a corporation. Section 7704(b) and § 1.7704-1(a) provide that, for purposes of § 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 that interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof for purposes 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 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), 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).

Portfolio has represented that the number of partners in Portfolio will be limited to 100 or fewer calculated pursuant to § 1.7704-1(h). No interest in Portfolio has been or will be issued in a transaction (or transactions) required to be registered under the 1933 Act. Accordingly, Portfolio will not be a "publicly traded partnership" within the meaning of § 7704(b).

Ruling # 2

Portfolio and Fund have requested a ruling that Portfolio and Fund will not recognize gain or loss under §§ 721(b) and 351(e) as a result of the contribution of assets by Fund to Portfolio.

Section 721(a) states generally that no gain or loss shall be recognized to a partnership, or to 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) states that § 721(a) shall 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.

Treas. Reg. § 351-1(c)(1) provides that a transfer of property will be considered to be a transfer to an investment company if (i) the transfer results, directly or indirectly, in diversification of the transferor's interests and (ii) the transferee is, among other possibilities, a corporation more than 80 percent of the value of whose assets are held for investment. A transfer will not result in diversification and therefore not constitute a transfer to an investment company, if a transferor transfers a diversified portfolio of stocks and securities as determined under § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F) but treating government securities as part of total assets but not as securities of an issuer. Treas. Reg. § 1.351-1(c)(6)(i).

After applying the law to the facts submitted and the representations made, we conclude that Portfolio and Fund will not recognize gain or loss under §§ 721(b) and 351(e) as a result of the contributions of assets by Fund to Portfolio. We express no opinion about whether subsequent transfers of stock and securities to Portfolio by any transferor will affect the tax consequences of the original transfers.

Ruling # 3

Portfolio and Fund have requested permission to aggregate built-in gains and losses from qualified financial assets contributed to Portfolio with built-in gains and losses from revaluations of qualified financial assets held by Portfolio for the purpose of making § 704(c) and reverse § 704(c) allocations.

Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner is shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Section 1.704-3(a)(1) states that the purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under § 704(c), a partnership must allocate income, gain, loss, and deductions with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market

value at the time of the 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 under § 1.704-1(b)(2)(iv)(f)(reverse § 704(c) allocations). A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of §§ 704(b) and (c).

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

Section 1.704-3(e)(3) sets forth a special rule allowing certain securities partnerships to make reverse § 704(c) allocations on an aggregate basis. Specifically, § 1.704-3(e)(3)(i) provides that, for purposes of making reverse § 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purposes of § 704(c). Once a partnership adopts an aggregate approach, the partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership.

Section 1.704-3(e)(3)(iii)(A) defines a securities partnership as a partnership that is either a management company or an investment partnership, and that makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership). Under § 1.704-3(e)(3)(iii)(B)(1), a partnership is a management company if it is registered as a management company under the 1940 Act.

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 property for purposes of the straddle rules). For a management company, qualified financial assets also include the following, even if not actively traded: shares of stock in a corporation; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

Section 1.704-3(e)(3)(iv) and (e)(3)(v) describe two approaches to making aggregate reverse § 704(c) allocations that are generally reasonable -- the partial netting approach and the full netting approach. However, § 1.704-3(e)(3)(i) provides that other approaches may be reasonable in appropriate circumstances.

Section 1.704-3(a)(10) provides that an allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse § 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequence of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

Furthermore, § 1.704-3(e)(3)(vi) provides that the character and other tax attributes of gain or loss allocated to the partners under an aggregate approach must: (A) preserve the tax attributes of each item of gain or loss realized by the partnership; (B) be determined under an approach that is consistently applied; and (C) not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability. Portfolio has represented that its allocations have complied and will comply with § 1.704-3(e)(3)(vi).

The aggregation rule of § 1.704-3(e)(3) applies only to reverse § 704(c) allocations. Therefore, a securities partnership using an aggregate approach must generally account for any built-in gain or loss from contributed property separately. The preamble to § 1.704-3(e)(3) explains that the final regulations do not authorize aggregation of built-in gains and losses from contributed property with built-in gains and losses from revaluations because this type of aggregation can lead to substantial distortions in the character and timing of income and loss recognized by contributing partners. T.D. 8585, 1995-1 C.B. 120, 123. However, the preamble also recognizes that there may be instances in which the likelihood of character and timing distortions is minimal and the burden of making § 704(c) allocations separate from reverse § 704(c) allocations is great. Consequently, § 1.704- 3(e)(4)(iii) authorizes the Commissioner to permit, by published guidance or 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, Portfolio will use the partial netting approach described in § 1.704-3(e)(3)(iv). Portfolio’s burden of making § 704(c) allocations separate from reverse § 704(c) allocations is represented to be substantial. In addition, the likelihood that this type of aggregation could be abused by Portfolio and its partners is minimal. It is represented that Fund is a "publicly offered regulated investment company" as defined in § 67(c)(2)(B) and § 1.67-2T(g)(3)(ii).

After applying the relevant law to the facts presented and the representations made, we conclude that Portfolio may aggregate built-in gains and losses from qualified financial assets contributed to Portfolio by Fund with built-in gains and losses from revaluations of qualified financial assets held by Portfolio for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations, provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or

loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

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 about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction(s) that are not specifically covered by the above rulings. Ruling three is limited to allocations of gain or loss from the sale or other disposition of qualified financial assets made under § 704(b), § 704(c)(1)(A), and § 1.704-3(a)(6). Specifically, no opinion is expressed concerning (i) whether Fund qualifies as a RIC that is taxable under subchapter M, part I of the Code, (ii) allocations of items other than items of gain or loss from the sale or other disposition of qualified financial assets, or (iii) the aggregation of built-in gains and losses from qualified financial assets contributed to Portfolio other than those described above. In addition, Portfolio must maintain sufficient records to enable it and its partners to comply with §§ 704(c)(1)(B) and 737.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Portfolio and Portfolio's second authorized representative.

Sincerely,
David R. Haglund
Senior Technician Reviewer, Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes