

## Internal Revenue Service

## Department of the Treasury

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### Legend

PRS =

FEEDER1 =

FEEDER2 =

MANAGER =

TRUST =

STATE =

DATE1 =

DATE2 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

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This responds to your representatives' letter dated August 6, 1999, and subsequent correspondence, written on behalf of PRS, requesting rulings under § 704(c) of the Internal Revenue Code.

## FACTS

MANAGER and its affiliates currently provide investment management services to three separate mutual fund families. MANAGER plans on consolidating the operations of the three fund families using a Master-Feeder structure. Under the Master-Feeder structure, each portfolio (the "feeders") invests 100 percent of its assets into a corresponding master (structured as a partnership), where the assets are managed in accordance with the established investment guidelines which mirror that of the feeders. The master partnership then allocates the net investment income and realized and unrealized gains to the feeders on a daily basis. The key benefit of this structure is that it allows mutual funds with the same investment objectives to pool their assets and be managed as a single portfolio, thereby creating economies of scale while allowing each feeder to be marketed individually.

MANAGER plans on consolidating the three fund families under master partnerships created as series of TRUST. PRS is one such master partnership. It was formed on DATE1 as part of a new series of TRUST and represents that it will be treated as a partnership for federal tax purposes under §§ 301.7701-2 and 301.7701-3 of the Administration and Procedure Regulations. In accordance with the master-feeder arrangement, PRS represents a segregated portfolio to be managed in accordance with its stated objective by investing in a portfolio of securities. For accounting purposes, PRS maintains separate books, records, and operating results from other partnerships created as part of TRUST's new series. Moreover, PRS will not have an interest in any of the other partnerships created as part of TRUST's new series. Because currently all three fund families do not offer identical series of funds, each newly created master partnership may not have funds from all three fund families as partners.

PRS will maintain a single book and tax capital account for each of its partners. The initial balance of each partner's book capital account will reflect the amount of money and the fair market value of the property contributed to PRS and the initial balance of each partner's tax capital account will reflect the money and adjusted tax basis of the property contributed to PRS. PRS will revalue its investment portfolio to fair market value as of the close of each day. PRS will adjust each partner's book 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. PRS will use the partial netting method of making aggregate reverse § 704(c) allocations.

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PRS also represents that (1) it will be registered as an open-end management company under the 1940 Act; (2) substantially all of its property will consist of readily tradeable securities; (3) allocations of taxable income, gain, loss, deduction, and credit will comply with the regulations promulgated under § 704(b) and (c); (4) it will qualify as a “securities partnership” within the meaning of § 1.704-3(e)(3)(iii) of the Income Tax Regulations; and, (5) PRS’s revaluations and the corresponding allocations of tax items are not made with a view toward 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.

PRS’s partners are FEEDER1 and FEEDER2. FEEDER1 will contribute assets with a fair market value on DATE2 of approximately a, and a built-in gain on DATE2 of approximately b, consisting of a gross built-in gain of c and a gross built-in loss of d. FEEDER2 will contribute assets with a fair market value on DATE2 of approximately e, and a built-in gain on DATE2 of approximately f, consisting of a gross built-in gain of g and a gross built-in loss of h. PRS anticipates that it may add new partners in the future. Any future partners may contribute securities, with built-in gain or loss, to PRS, but only if the securities are consistent with PRS’s stated objective. Any new partner must satisfy the following criteria: (1) the partner is registered under the 1940 Act and qualifies as a Qualified Contributor; (2) the contribution is made and accepted for valid business purposes; and, (3) PRS will document any subsequent contribution on its tax return.

PRS requests rulings that its method of making reverse § 704(c) allocations is reasonable under § 1.704-3(e)(3) and that it may aggregate built-in gains and losses from qualified financial assets contributed to it by a partner with built-in gains and losses from revaluations of qualified financial assets held by it for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations.

## LAW AND ANALYSIS

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 pre-contribution gain or loss. Under § 704(c), a partnership must allocate income, gain, loss, and deduction 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).

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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)(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.

Section 704(c) generally applies on a property-by-property basis. Section 1.704-3(a)(2). 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). 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)(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)(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.

Sections 1.704-3(e)(3)(iv) and (v) describe two approaches to making aggregate reverse § 704(c) allocations that are generally reasonable - the partial netting approach and the full netting approach.

Section 1.704-3(e)(3)(iv) provides that to use the partial netting approach, the partnership must establish appropriate accounts for each partner for the purpose of taking into account 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,

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on the date of each capital account restatement, the partnership: (A) nets its book gains and losses from qualified financial assets since the last capital account restatement and allocates the net among 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 the partners in a manner that reduces the disparity between book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

Section 1.704-3(e)(3) only applies 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 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. *Id.* 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, PRS's burden of making § 704(c) allocations separate from reverse § 704(c) allocations is substantial. FEEDER1 and FEEDER2 will contribute approximately i different assets to PRS. Unless the Commissioner permits PRS to aggregate § 704(c) gains and losses with reverse § 704(c) gains and losses, PRS will have to track most of the unrealized gains and losses from revaluations on a property-by-property basis. Tracking most of the unrealized gains and losses from revaluations on a property-by-property basis largely nullifies the benefits of the aggregate approach for making reverse § 704(c) allocations.

The tax characteristics of PRS's partners, the size of their interests in PRS, and the characteristics of the assets to be contributed to PRS reduce the likelihood of abuse of an aggregate approach. Accordingly, based on the facts presented and the representations made, we conclude that PRS may aggregate built-in gains and losses from qualified financial assets contributed to PRS by its partners with built-in gains and losses from revaluations of qualified financial assets held by PRS for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations. In addition, PRS's use of the partial netting method of making § 704(c)(1)(A) allocations is reasonable within the meaning of § 1.704-3(e)(3).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the

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Code. Specifically, no opinion is expressed concerning PRS's classification as a partnership for federal tax purposes, the steps taken in the consolidation of fund families into PRS, or the tax consequences of any partner's contribution of assets to PRS. Additionally, this ruling applies only to the contributions to PRS for which the taxpayer supplied specific information concerning the fair market value and the built-in gain and loss in the contributed assets as outlined above, and not to any other contributions by any current or future partner.

This ruling is directed only to the taxpayer requesting 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, a copy of this letter is being sent to PRS's two authorized representatives.

Sincerely,

**Signed/David R. Haglund**

Senior Technician Reviewer, Branch 1  
Office of the Assistant Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

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Copy of this letter for § 6110 purposes