

## Internal Revenue Service

## Department of the Treasury

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### Legend:

Master Trust =

Master Fund =

Feeder Funds =

State X =

State Y =

Dear

This responds to your request for a ruling dated September 23, 1999, submitted by your authorized representative on behalf of the Feeder Funds. The ruling requested is as follows: Each of the Feeder Funds which invests in the Master Fund, as a partner in the Master Fund, will be deemed to own a proportionate share of each of the assets of the Master Fund and will be deemed to be entitled to the proportionate income of the Master Fund attributable to such share for purposes of determining whether such Feeder Fund satisfies the requirements of sections 851(b)(2), 851(b)(3), 852(b)(5), 853 and 854 of the Internal Revenue Code of 1986. For purposes of these sections, the interest of a Feeder Fund in the Master Fund shall be determined in accordance with each Feeder Fund's capital interest in that Master Fund.

## FACTS

Master Trust is a business trust established under the laws of State Y under a Declaration of Trust. Master Trust will be registered as an open-end management investment company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. (the "1940 Act").

Master Trust has established a series (the "Master Fund") into which the Feeder Funds may invest. The taxpayers represent that the Master Fund will be treated as a partnership under section 301.7701-3 (b)(1), and will not be treated as a publicly traded partnership under section 1.7704-1(h).

The Feeder Funds are corporations incorporated under the laws of State X that are or will be registered under the 1940 Act as open-end management investment companies. Each Feeder Fund will qualify for and elect status as a regulated investment company ("RIC") under subchapter M of the Code.

It is proposed that each of the Feeder Funds will invest substantially all of its assets in the Master Fund in exchange for an interest therein pursuant to a private placement of interests in the respective Master Fund. Such investment will in each case constitute more than 90% of the gross assets of the Feeder Fund.

A Feeder Fund's interest in the Master Fund will be determined by reference to its capital account in the Master Fund. The number of holders of interests in the Master Fund will be limited to fewer than 100. Interests in the Master Fund will be offered and sold only to institutional investors. No individual, S corporation, partnership or grantor trust, a grantor of which includes an individual, S corporation or partnership, will be issued interests in the Master Fund.

Each holder of an interest in the Master Fund will be allocated its pro rata share of each item of income of the Master Fund and will bear its pro rata share of the expenses of the Master Fund. The Master Fund will allocate taxable income, gain, loss, deduction and credit under sections 704(b) and (c) and the applicable regulations.

The taxpayers represent that, except as required by section 704(c) and section 1.704-1(b)(4) of the regulations, allocations of specific items of income, gain, loss, deduction and credit will be proportionate to the interests of the holders in the Master Fund.

The taxpayers represent that the organization of the Master Fund in a manner to enable its classification as a partnership was not made to enable a partner that is a RIC to make distributions that would be prohibited under Rev. Rul. 89-81, 1989-1 C.B. 226, had the RIC invested directly in the assets of the Master Fund.

The taxpayers represent that, for purposes of determining the required

distribution under section 4982(a)(1) of the Code, the Feeder Funds will account for their shares of partnership items of income, gain, loss, and deduction as they are taken into account by the partnership, as required by Rev. Rul. 94-40, 1994-1 C.B. 274.

## LAW AND ANALYSIS

Section 851(b) of the Code 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) of the Code 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) of the Code 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) of the Code 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 853(a) of the Code 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) of the Code 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) of the Code 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) of the Code provides that the term "aggregate dividends received" includes only dividends received from domestic corporations.

Section 854(b)(4) of the Code 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 of the Code 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) of the Code 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) of the Code which 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 includible 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, 100<sup>th</sup> Cong., 2d Sess. 93 (1988).

Under subchapter K of the Code, 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 each Holder (i.e., Feeder Fund) to qualify as a RIC under the diversification tests of section 851 of the Code, the aggregate approach will have to be applied to each Feeder Fund's partnership interest in the Master Fund. As an aggregate, each Holder 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) of the Code 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) of the Code. 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 interest held by the Holders. The flush language of section 851(b) mandates an aggregate approach in applying the 90% 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 underlying partnership assets for purposes of section 851(b)(2), but not for purposes of sections 851(b)(3), 852(b)(5) and 853.

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) of the regulations 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 of the Code.

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 each 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 each Feeder Fund satisfies the requirements of section 851(b)(2), 851(b)(3), 853(a), and 854 of the Code. For purposes of these sections, the interest of each Feeder Fund in the Master Fund shall be determined in accordance with the Feeder Fund's capital interest in the Master Fund.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Further, except as specifically ruled upon above, no opinion is expressed or implied regarding the federal income tax consequences of the transactions described above to any other taxpayer.

that is no or may become a Holder of an interest in either Master Fund.

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

Sincerely yours,  
Assistant Chief Counsel  
(Financial Institutions & Products)

By: \_\_\_\_\_  
William E. Coppersmith  
Chief, Branch 2