Internal Revenue Service

Department of the Treasury

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LEGEND

Fund 1 =
Fund 2 =
Fund 3 =
Fund 4 =
Fund 5 =
Fund 6 =

D1 =
D2 =
D3 =
D4 =
D5 =

Manager =

State =

Dear

This letter responds to your February 18, 2000, letter, and subsequent correspondence on behalf of Fund 2, requesting certain rulings under the Internal Revenue Code.

FACTS

According to the information submitted, Fund 1 (formed on D1), Fund 2 (formed on D2), Fund 3 (formed on D3), and Fund 4 (formed on D4) (collectively "the Funds") are separate master fund portfolios in a "master-feeder" investment structure. The Funds are series of registered investment companies sponsored by Manager. Specifically, Fund 1, Fund 2, and Fund 3 are subtrusts of Fund 5, and Fund 4 is a subtrust of Fund 6. Fund 5 and Fund 6 are trusts organized under State law and are open-end management investment companies under the Investment Company Act of 1940 (the 1940 Act). Fund 4 has substantially the same investment objective as Fund 2.

Investments in Fund 5 and Fund 6 may only be made by certain institutional investors such as regulated investment companies (RICs) and segregated asset accounts. Generally, no individual, S corporation, partnership, or grantor trust beneficially owned to any extent by an individual, S corporation, or partnership may invest in any portfolio of Fund 5 or Fund 6. The interest of the holders in any portfolio or series is limited to the net assets of that portfolio or series and does not extend to the assets of any other investment vehicles of Fund 5 or Fund 6.

A portfolio interest entitles the holder to receive a pro rata share of distributions of income and capital gain and an allocable share of any losses the portfolio experiences. Holders' capital accounts are maintained by the portfolio, and any increases or decreases in a holder's investment are made by adjusting the capital account balance. The allocations of taxable income, gain, loss, deductions and credits under each agreement transferring a beneficial interest have been drafted with the intent to comply with the regulations promulgated under §§ 704(b) and (c) of the Internal Revenue Code. Each holder is entitled to a pro rata share, in proportion to its capital account, of the assets of a separate portfolio upon its liquidation and may only look to the assets of the separate portfolio on liquidation, redemption, or termination of the separate portfolio.

On D5, Fund 1 contributed all of its assets to Fund 3 and Fund 4 (the Fund 1 Contributions) and Fund 2 contributed all of its assets to Fund 4 (the Fund 2 Contribution) (collectively the Contributions), in exchange for interests in those funds. Thereafter, both Fund 1 and Fund 2 liquidated, distributing the interests in Fund 3 and Fund 4 they received to their feeder funds in complete redemption of the interests in Fund 1 and Fund 2 held by those funds. The purpose of these Contributions was to consolidate the assets of what were four master funds with substantially similar investment objectives, into two master funds, i.e. Fund 3 and Fund 4, thereby eliminating duplicative expenses and achieving economies of scale.

With regard to its Contribution, Fund 2 represents that it contributed to Fund 4 and Fund 4 represents that it held immediately after the Contribution, a diversified portfolio of stocks and securities. For purposes of this representation, a portfolio of stocks and securities is diversified if it satisfies § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F), except that in applying § 368(a)(2)(F)(iv), Government securities are included in determining total assets, unless the Government securities are acquired to meet § 368(a)(2)(F)(ii).

The Funds also represent that none of their respective investors acquired their interests in any of the Funds in exchange for any asset other than cash or other permissible investments of "investment partnerships" within the meaning of § 731(c)(3)(C)(i).

RULINGS REQUESTED

Fund 2 requests rulings that :

1) Fund 2 will not recognize any gain or loss as a result of the Contribution. Specifically, Fund 2 requests a ruling that Fund 4 is not an "investment company" as defined by § 721(b) and § 351(d). Fund 2 also requests a ruling concerning its basis in its Fund 4 interests.

2) No investor in Fund 2 will recognize any gain or loss in connection with the issuance or receipt of interests in Fund 4 in exchange for and in liquidation of interests in Fund 2. If the Contribution qualifies for nonrecognition for the investors, Fund 2 requests that the investors' bases and holding periods in their new respective properties be determined accordingly.

DISCUSSION

1.a. Pursuant to § 721, no gain or loss shall be recognized to Fund 2 as a result of the Fund 2 Contribution.

Section 721(a) provides that neither a partner nor a partnership will recognize gain or loss on a contribution of assets to a partnership in exchange for a partnership interest.

Section 721(b) provides that subsection (a) shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of § 351) if the partnership were incorporated.

Section 351(a) provides that no gain or loss will be recognized if one or more persons transfers property to a corporation solely in exchange for stock or securities in the corporation and immediately after the exchange the transferors control the transferee corporation. Section 351(e)(1) provides that § 351(a) will not apply to a transfer of property to an investment company.

Section 1.351-1(c)(1) of the Income Tax Regulations provides that a transfer to an investment company will occur when (i) the transfer results, directly or indirectly, in diversification of the transferors' interests and (ii) the transferee is a regulated investment company (RIC), real estate investment trust (REIT), or a corporation more than 80 percent of the value of whose assets (excluding cash and non-convertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in RICs or REITs.

Section 1002 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997) (the Act), amends § 351(e) for transfers after June 8, 1997, in taxable years ending after such date, subject to certain transitional relief provisions. Section 1002 of the Act is intended to expand the types of assets considered in determining whether a transfer is to a transferee described in § 1.351-1(c)(1)(ii)(c) to include certain assets in addition to "readily marketable stocks or securities" and interests in RICs or REITs. However, the Act is not intended to alter the requirement of § 1.351-1(c)(1)(i) that a transfer of property will be considered to be a transfer to an investment company under § 351(e) only if the transfer results, directly or indirectly, in diversification of the transferors' interests. See S. Rep. No. 105- 33, 105th Cong., 1st Sess. 131 (1997); H.R. Rep. No. 105-148, 105th Cong., 1st Sess., 447 (1997); H.R. Rep. No. 105-220, 105th Cong., 1st Sess. 516-17 (1997).

Section 1.351-1(c)(5) provides that a transfer ordinarily results in diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in the exchange. It further provides that, if a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification. Rev. Rul. 87-9, 1987-1 C.B. 133, provides that a transfer to a corporation of shares of corporation Y stock by one transferor, and a transfer of cash by another transferor will be treated as a transfer of nonidentical assets under § 1.351-1(c).

Section 1.351-1(c)(6)(i) provides that (1) a transfer of stocks and securities will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities and (2) a portfolio of stocks and securities is considered to be diversified if it satisfies the 25- and 50-percent tests of § 368(a)(2)(F)(ii), applying the relevant provisions of § 368(a)(2)(F), except that government securities are included in total assets for purposes of the denominator of the 25- and 50-percent tests (unless acquired to meet the 25- and 50-percent tests), but are not treated as securities of an issuer for purpose of the numerator of the 25- and 50-percent tests.

An investment company is diversified within the meaning of § 368(a)(2)(F)(ii) if not more than 25 percent of the value of its assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is investment in the stock and securities of five or fewer issuers.

After applying the relevant law to the facts submitted and the representations made, we conclude that the transfer of property by Fund 2 to Fund 4 would not be a transfer to an investment company within the meaning of § 351 and § 1.351-1(c) if

Fund 4 was incorporated, provided that this is the only transfer to Fund 4 (aside from the transfer from Fund 1). Therefore, under § 721, no gain or loss shall be recognized by Fund 2 as a result of the Contribution.

1.b. Fund 2's basis in its interest in Fund 4 shall be determined accordingly.

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Section 723 provides that the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Based on the finding that Fund 2 recognized no gain or loss on its Contribution, Fund 2 will have a basis in the interest received in Fund 4, equal to the amount of money and aggregate adjusted bases (determined immediately prior to the Contribution to Fund 4) of the other property contributed to Fund 4.

2.a. Pursuant to § 731, no investor in Fund 2 will recognize any gain or loss under § 731 in connection with Fund 2's receipt of an interest in Fund 4 in exchange for and in liquidation of interests in Fund 2.

Section 731(a) provides that in the case of a distribution by a partnership to a partner, (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution; (2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in §§ 731(a)(2)(A) or (B) is distributed to such partner, loss shall be recognized to the extent of the adjusted basis of such partner's interest over the sum of – (A) any money distributed, and (B) the basis to the distributee, as determined under § 732, of any unrealized receivables (as defined in § 751(c)) and inventory (as defined in § 751(d)).

Section 731(c)(1) provides that for purposes of §§ 731(a)(1) and 737 – (A) the term "money" includes marketable securities, and (B) such securities shall be taken into account at their fair market value as of the date of the distribution.

Section 731(c)(2)(A) provides that for the purposes of § 731(c) the term "marketable securities" means financial instruments and foreign currencies which are,

as of the date of the distribution, actively traded (within the meaning of § 1092(d)(1)).

Section 731(c)(2)(B)(iii) provides that for the purposes of § 731(c) the term "marketable securities" includes any financial instrument the value of which is determined substantially by reference to marketable securities.

Section 731(c)(2)(C) provides that the term "financial instrument" includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives.

Section 731(c)(3)(A)(iii) provides that § 731(c)(1) shall not apply to the distribution from a partnership of a marketable security to a partner if such partnership is an investment partnership and such partner is an eligible partner thereof.

Section 731(c)(3)(C)(i) provides that the term "investment partnership" means any partnership which has never been engaged in a trade or business and substantially all of the assets (by value) of which have always consisted of (I) money, (II) stock in a corporation, (III) notes, bonds, debentures, or other evidences of indebtedness, (IV) interest rate, currency, or equity notional principal contracts, (V) foreign currencies, (VI) interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described in any other subclause of this clause or in any commodity traded on or subject to the rules of a board of trade or commodity exchange, (VII) other assets specified in regulations prescribed by the Secretary, or (VIII) any combination of the foregoing.

Section 731(c)(3)(C)(ii) provides that for the purposes of § 731(c)(3)(A)(iii) a partnership shall not be treated as engaged in a trade or business by reason of (I) any activity undertaken as an investor, trader, or dealer in any asset described in § 731(c)(3)(C)(i), or (II) any other activity specified in regulations prescribed by the secretary.

Section 731(c)(3)(C)(iii) provides that the term "eligible partner" means any partner who, before the date of the distribution, did not contribute to the partnership any property other than assets described in § 731(c)(3)(C)(i).

Fund 2 represents that none of its investors acquired their interests in exchange for any asset other than cash or other permissible investments of "investment partnerships" within the meaning of § 731(c)(3)(C)(i).

Section 751(c) provides, in part, that for the purposes of subchapter K, the term "unrealized receivables" includes, (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered or to be

rendered.

Section 751(d) provides that for the purposes of subchapter K, the term "inventory" means – (1) property of the partnership of the kind described in § 1221(a)(1), (2) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in § 1231, (3) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under § 1246(a) (relating to gain on foreign investment company stock), and (4) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in § 751(d)(1)-(3).

After applying the relevant law to the facts submitted and the representations made, we conclude that the Fund 2 Contribution and the related distribution involved the distribution of property from an "investment partnership" to "eligible partners," as those terms are used in § 731(c)(3)(A)(iii). Thus, under § 731(a)(1), no "money" was distributed by or to Fund 2 or its investors. Therefore, no investor in Fund 2 shall recognize any gain as a result from the Contribution, or the related distributions. Further, we conclude that no "unrealized receivables," or "inventory," as those terms are used in § 731, were distributed to any investor in Fund 2. Therefore, under § 731(a)(2), no investor in Fund 2 shall recognize any loss as a result from the Contribution or the related distributions.

2.b. The investors' bases and holding periods in their new properties shall be determined accordingly.

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

Section 735(b) provides that in determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of § 735(a)(2)), there shall be included the holding period of the partnership, as determined under § 1223, with respect to such property.

Section 1223(2) provides that in determining the period for which the taxpayer has held property however acquired there shall be included in the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

Based on the findings that no investor in Fund 2 recognized gain or loss upon

the Contribution, each investor in Fund 2 receiving an interest in Fund 4, will have a basis in such interest in Fund 4 equal to its adjusted basis (determined immediately prior to the distribution of such interest) in Fund 2. Furthermore, provided that any such interest in Fund 4 is a capital asset, each investor will have a holding period, as determined under § 1223, for such interest.

CONCLUSIONS

As stated above, after applying the relevant law to the facts submitted and the representations made, we find that neither Fund 2, nor any of its interest holders, will recognize gain or loss as result of the Contribution. Furthermore, the bases and holding periods of all of the assets involved to Fund 2 and its investors, will be determined under §§ 722, 723, 732(b), 735(b) and 1223, as applicable.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express no opinion about whether subsequent transfers of property to Fund 4 by any transferor would be considered to be part of the original transfers, thereby potentially affecting the tax consequences of the original transfers. Additionally, we express no opinion about whether the above-referenced transfers are part of a plan to achieve diversification without recognition of gain under § 1.351-1(c)(5).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling is being sent to the taxpayer.

This ruling is directed only to the taxpayer requesting it, Fund 2. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely Yours,
Robert Honigman
Acting Assistant to the Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)