Internal Revenue Service

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Legend

Portfolio	=
Fund 1	=
Fund 2	=
Trust	=
Date 1	=
<u>V</u>	=
<u>W</u>	=
<u>X</u>	=
<u>Y</u>	=
<u>Z</u>	=

Dear

This letter responds to a letter dated July 24, 1998, on behalf of Portfolio, requesting a ruling under § 704(c) of the Internal Revenue Code. Specifically, a ruling has been requested that Portfolio may 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 making § 704(c)(1)(A) and reverse § 704(c) allocations.

FACTS

The following representations have been made. Fund 1 and Fund 2 are registered as open-end diversified management investor companies under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. (the "1940 Act"), and have elected to be taxed as regulated investment companies (RICs) under § 851. Together, Fund 1 and Fund 2 will form Portfolio. Fund 1 and Fund 2 share a similar investment objective and plan to pursue their objective jointly through Portfolio. Portfolio is a separate share of Trust and will be classified as a partnership for federal tax purposes under § 301.7701-3(b)(1)(i).

To form Portfolio, Fund 1 will contribute property consisting primarily of V lots of securities with a fair market value on Date 1 of approximately W. On Date 1, Fund 1's assets had an aggregate built-in gain of X and an aggregate built-in loss of Y. Fund 2 will contribute cash in the amount of Z.

In exchange for their contributions to Portfolio, Fund 1 and Fund 2 (as well as any future investors) will receive partnership interests in Portfolio. Each partnership interest represents an equal proportionate interest in Portfolio, none having priority or preference over another. Portfolio anticipates that any additional contributing partners will also be management investment companies registered under the 1940 Act and qualified as RICs. It is possible, however, that non-RIC investors may invest in Portfolio from time to time.

Portfolio will maintain a single capital account for each of its partners, and 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 will use the partial netting method for making aggregate reverse § 704(c) allocations.

Portfolio represents that (i) it will be registered as an open-end management company under the 1940 Act; (ii) substantially all of its property will consist of readily tradeable securities; (iii) it will comply in all respects with the capital account maintenance rules set forth in § 1.704-1(b)(2)(iv); (iv) it will qualify as a “securities partnership” within the meaning of § 1.704-3(e)(3)(iii); (v) its 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 its partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability; and, (vi) it was not organized 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 Portfolio. It is anticipated that Fund 1's interest in Portfolio will exceed 90 percent for the foreseeable future.

DISCUSSION

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 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 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 purpose of § 704(c). Section 1.704-3(e)(3)(i) identifies the approach that Portfolio will use for aggregating reverse § 704(c) gains as generally reasonable. 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. 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 personal 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.

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 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 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, Portfolio's burden of making § 704(c) allocations separate from reverse § 704(c) allocations is represented to be substantial. Fund 1 will contribute a large number of assets to Portfolio. Unless the Commissioner permits Portfolio to aggregate § 704(c) gains and losses with reverse § 704(c) gains and losses, Portfolio 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.

CONCLUSION

We conclude that Portfolio may aggregate built-in gains and losses from qualified financial assets contributed to Portfolio by Fund 1 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. We further conclude that Portfolio may aggregate built-in gains and losses from qualified financial assets contributed by future partners with built-in gains and losses from revaluations of qualified financial assets for purposes of making § 704(c)(1)(A) and reverse § 704(c) allocations to the extent that the future partners are qualified contributors. A qualified contributor is a partner for which the following conditions are satisfied: (1) the partner is registered under the 1940 Act and would be considered a "publicly offered regulated investment company" as defined in § 67(c)(2)(B) and § 1.67-2T(g)(3)(ii); (2) the contribution is made and accepted for valid business purposes (and not made primarily for tax motivated reasons (other than the fact that the contribution to Portfolio is tax-free)); and (3) to the extent Portfolio relies on this ruling for the contribution, Portfolio will document any such contribution on its tax return filed subsequent to the contribution.

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. In particular, we express no opinion on whether Portfolio is a publicly traded partnership or on whether the transfer of assets to Portfolio is taxable under § 721(b).

This letter is issued only to the person who requested it. Under § 6110(k)(3), it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this ruling is being sent to your authorized representative.

Sincerely yours,

Jeff Erickson
Assistant to the Branch Chief, Branch 3
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures:
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