NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

AGGREGATION ISSUES FACING SECURITIES PARTNERSHIPS UNDER SUBCHAPTER K

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Report No. 1220

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Introduction

This report[1] addresses certain key tax issues facing securities partnerships under subchapter K.[2] Specifically, this report discusses rules that permit securities partnerships to use an aggregation method to account for certain gains and losses resulting from revaluations of partnership property and suggests certain changes to those rules. This report also discusses the application of the basis adjustment rules of sections 734(b) and 743(b) to securities partnerships.[3]

This report is divided into three parts. Part I contains a general summary of the current law relating to the issues described above. Part II contains a list of our recommendations. Part III contains a detailed discussion of our recommendations.

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[1] This report was prepared by members of the Committee on Partnerships of the Tax Section of the New York State Bar Association. The principal drafters of this report were Matthew Lay and Eric Sloan. Substantial contributions were made by James Brown, Stephen Foley, David Mayo, Andrew Needham, Joel Scharfstein, and Alison Rosier. Helpful comments were received from Andrew Berg, Kimberly Blanchard, Peter Blessing, Andrew Braiterman, Edward Gonzalez, Stephen Land, Deborah Paul, Michael Schler, David Schnabel, Peter Schuur, and Linda Swartz.

[2] Unless otherwise indicated, all "section" or "subchapter" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" or "regulations" references are to the Treasury regulations promulgated under the Code.

[3] Recent legislative proposals concerning the tax treatment of carried interests are beyond the scope of this report. For a discussion of certain issues raised by these proposals, *see NYSBA Makes Recommendations for Carried Interest Legislation*, 2008 TNT 187-42 (Sep. 25, 2008) (New York State Bar Association, Tax Section Report No. 1166, Report on Proposed Carried Interest and Fee Deferral Legislation).

I. Summary of Current Law

A. Securities Aggregation

1. Background

Prior to its amendment by the Tax Reform Act of 1984 (the "1984 Act"), section 704(c) of the Internal Revenue Code of 1954, as amended, provided that, in determining a partner's distributive share of partnership items, depreciation, depletion, or gain or loss with respect to property contributed by a partner was generally allocated among the partners in the same manner as if the property had been purchased by the partnership. The statute, however, permitted a partnership, if the partnership agreement so provided, to make allocations with respect to contributed property so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution. The 1984 Act amended section 704(c) to require, rather than permit, that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner be 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.

The Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") issued proposed regulations under section 704(c) in 1992 (the "1992 Proposed Regulations").[4] In general, the 1992 Proposed Regulations provided that property could not be aggregated for purposes of making allocations under section 704(c). However, the regulations permitted property (other than real property) that was included in the same general asset account and contributed by a partner in a single taxable year of the partnership to be treated as one item

[4] Allocations Reflecting Built-in Gain or Loss on Property Contributed to a Partnership (PS-164-84), 57 Fed. Reg. 61,345 (Dec. 24, 1992).

of property.[5] In addition, the proposed regulations permitted Treasury and the IRS to provide in published guidance that other classes of items may be aggregated for purposes of section 704(c).[6] This regulatory flexibility appears to have been driven by the following observation made by Treasury and the IRS in the preamble to the proposed regulations:

> The statute grants broad regulatory authority to determine how these allocations should be made. This resulted from congressional concern that the existing regulations under the formerly elective method *did not provide sufficient flexibility and were overly burdensome for taxpayers in situations where there was little potential for abuse*. *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 857 (1984); S. Prt. No. 169, Vol. I, 98th Cong., 2d Sess. 214-15 (1984).[7]

Treasury and the IRS received many comments on the proposed regulations, some of which requested that aggregation of property be permitted in various situations.[8] Most provisions of the 1992 Proposed Regulations were finalized in 1993.[9] The final regulations reserved on two issues: the remedial allocation method, and aggregation of securities and similar investments by securities partnerships for purposes of section 704(b) and (c). On the same day, Treasury and the IRS issued temporary regulations (the "1993 Temporary Regulations") addressing those two issues.[10] The 1993 Temporary Regulations were finalized, with certain

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[5] *Id.*

[6] *Id.*

[7] *Id.* (Emphasis added.)

[8] *See*, *e.g.*, *NYSBA Comments on Partnership Allocation Proposed Regs*, 93 TNT 258-26 (Dec. 21, 1993) (New York State Bar Association, Tax Section Report on Proposed Regulation Section 1.704-3 Relating to Allocations Under Section 704(c) of the Internal Revenue Code); *Christy and Viener Attorney Submits Copy of Article*, 93 TNT 94-22 (Apr. 30, 1993) (attaching article by David G. Levere, *A Proposal for Applying Section 704(c) to Securities Partnerships*, 59 Tax Notes 249 (Apr. 12, 1993)); *Commentator Suggests Method of Making Reverse Allocations for Investment Partnerships*, 93 TNT 84-33 (Apr. 16, 1993) (comments submitted by Christopher P. McConnell of Deloitte & Touche); Attorney Recommends Treating Partnership Marketable Securities on an Aggregate Basis, 93 TNT 74-28 (Apr. 2, 1993) (comments submitted by Stephen D.D. Hamilton of Drinker Biddle & Reath).

[9] T.D. 8500, 58 Fed. Reg. 67,676 (Dec. 22, 1993).

[10] Similar to the current regulations, the 1993 Temporary Regulations allowed securities partnerships to use an aggregate method to account for reverse section 704(c) gain from qualified financial assets. The definitions of

modifications, in 1994.[11] The current regulations, finalized in 1994, provide that allocations under section 704(c) must be made using a reasonable method that is consistent with the purpose of section 704(c).[12] Section 704(c) principles also apply to allocations with respect to property for which differences between book value[13] and adjusted tax basis are created when a partnership revalues partnership property under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*) (*i.e.*, "reverse section 704(c) allocations").[14]

The current regulations, like the 1992 Proposed Regulations, provide that section 704(c) generally applies on a property-by-property basis.[15] Therefore, in determining whether

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the terms "securities partnership" and "qualified financial assets" generally were narrower than in the final regulations promulgated in 1994.

[11] T.D. 8585, 59 Fed. Reg. 66,724 (Dec. 28, 1994).

[12] Treas. Reg. § 1.704-3(a)(1).

[13] As used in this report, the term "book" means the books of the partnership maintained in accordance with the provisions of Treas. Reg. § 1.704-1(b)(2)(iv).

[14] Under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*), a partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Capital accounts adjusted because of a revaluation will not be considered to be determined and maintained in accordance with the Treas. Reg. § 1.704-1(b)(2)(iv) unless (i) the adjustments are based on the fair market value of partnership property on the date of adjustment; (ii) the adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date; (iii) the partnership agreement requires that the partners' capital accounts be adjusted in accordance with Treas. Reg. § 1.704-1(b)(2)(iv)(*g*) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property; and (iv) the partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to the property be determined so as to take account of the variation between the adjusted tax basis and book value of the property in the same manner as under section 704(c). Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*) provides that the adjustments must be made principally for a substantial non-tax business purpose in connection with the following situations: (i) a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership; (ii) the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership; (iii) the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner, or (iv) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

[15] Treas. Reg. § 1.704-3(a)(2).

there is a disparity between adjusted tax basis and fair market value, the built-in gains ("BIG") and built-in losses ("BIL") on items of contributed or revalued property generally cannot be aggregated.

2. Treas. Reg. § 1.704-3(e)

Treas. Reg. § 1.704-3(e)(3)(i), however, provides that, for purposes of making reverse section 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets ("QFAs") using any reasonable approach that is consistent with the purposes of section 704(c). According to the preamble to the final regulations, securities partnerships were afforded this flexibility because Treasury and the IRS recognized that "[t]he frequency of capital account restatements under § 1.704-1(b)(2)(iv)(*f*) and the number of partnership assets may make it unduly burdensome for certain securities partnerships to make reverse section 704(c) allocations on an asset-by-asset basis."[16] This flexibility is not unlimited: once a partnership adopts an aggregate approach, the partnership must apply the same aggregate approach to all of its QFAs for all taxable years in which the partnership qualifies as a securities partnership.[17]

For this purpose, a "securities partnership" is a partnership that (i) is either an investment partnership or a management company, and (ii) makes "all of its section 704(b) allocations" in proportion to the partners' relative section 704(b) capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership) (the "Pro Rata Rule").[18] A partnership is an "investment partnership" if (i) on the date of each capital account restatement, the partnership holds QFAs

[16] T.D. 8585, 59 Fed. Reg. 66,724 (Dec. 28, 1994).

[17] As discussed below, the current regulations contain a transition rule allowing securities partnerships to use a reasonable method of accounting for allocations from revaluations prior to the effective date of the regulations.

[18] Treas. Reg. § 1.704-3(e)(3)(iii)(A).

that constitute at least 90 percent of the partnership's non-cash assets (the "90 Percent Test") and (ii) the partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach, to make revaluations at least annually.[19] A partnership is a "management company" if it is registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended.[20]

The regulations define QFAs as any personal property (including stock) that is actively traded, as defined in Treas. Reg. § 1.1092(d)-1 (defining actively traded property for purposes of the straddle rules).[21] For a management company, QFAs 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.[22]

Under the regulations, a partnership interest is not a QFA.[23] However, a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) must take into account the lower-tier partnership's assets and QFAs as follows: First, in determining whether the upper-tier partnership qualifies as an investment partnership,

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19 Treas. Reg. § 1.704-3(e)(3)(iii)(B)(*2*).

20 Treas. Reg. § 1.704-3(e)(3)(iii)(B)(*1*).

21 Treas. Reg. § 1.704-3(e)(3)(ii)(A).

22 Treas. Reg. § 1.704-3(e)(3)(ii)(B). In the preamble to the final regulations permitting securities aggregation, Treasury and the IRS explained that "[t]here is less reason to limit aggregation to easily valued assets when the partnership is registered as a management company under the 1940 Act, because a management company's valuation of its assets is closely regulated by the Securities and Exchange Commission." T.D. 8585, 59 Fed. Reg. 66,724 (Dec. 28, 1994).

23 Treas. Reg. § 1.704-3(e)(3)(ii)(C).

the upper-tier partnership must treat its proportionate share of the lower-tier partnership's assets as assets of the upper-tier partnership.[24] Second, if the upper-tier partnership adopts an aggregate approach, the upper-tier partnership must aggregate the gains and losses from its directly held QFAs with its distributive share of the gains and losses from the QFAs of the lower-tier partnership.[25]

The regulations describe two approaches to making aggregate reverse section 704(c) allocations that generally are reasonable — the partial netting approach and the full netting approach.[26] Other approaches, however, may be reasonable in appropriate circumstances.[27] The character and other tax attributes of gains or losses allocated to the partners under an aggregate approach must: (i) preserve the tax attributes of each item of gain or loss realized by the partnership; (ii) be determined under an approach that is consistently applied; and (iii) not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability.[28]

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[24] Treas. Reg. § 1.704-3(e)(3)(ii)(C)(*1*).

[25] Treas. Reg. § 1.704-3(e)(3)(ii)(C)(*2*).

[26] Under both approaches, 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, on the date of each capital account restatement, the partnership: (A) nets its book gains and book losses from QFAs since the last capital account restatement and allocates the net amount to its partners; (B) separately aggregates all tax gains and all tax losses from QFAs 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 the book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners. *See* Treas. Reg. § 1.704-3(e)(3)(iv) and Example 1 of Treas. Reg. § 1.704-3(e)(3)(ix). Under the full netting approach, on the date of each capital account restatement, the partnership: (A) nets its book gains and book losses from QFAs since the last capital account restatement and allocates the net amount to its partners; (B) nets tax gains and tax losses from QFAs since the last capital account restatement; and (C) allocates the net tax gain (or net tax loss) to the partners in a manner that reduces the book-tax disparities of the individual partners. *See* Treas. Reg. § 1.704-3(e)(3)(v) and Example 2 of Treas. Reg. § 1.704-3(e)(3)(ix).

[27] Treas. Reg. § 1.704-3(e)(3)(i).

[28] Treas. Reg. § 1.704-3(e)(3)(vi). *Cf.* Treas. Reg. § 1.704-3(a)(10) (an allocation method (or combination of methods) is not reasonable if the contribution of property (or the revaluation event) and the corresponding allocation of tax items with respect to the section 704(c) property are made with a view to shifting the tax consequences of

The aggregation rules apply only to reverse section 704(c) allocations. Therefore, a securities partnership using an aggregate approach generally must account for any BIG or BIL from contributed property separately. In the preamble to the final regulations under section 704(c), the Treasury and IRS explained that the regulations do not authorize aggregation of BIG and BIL from contributed property with BIG and BIL 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.[29] Treasury and the IRS, however, also recognized that there may be instances in which the likelihood of character and timing distortions is minimal and the burden of making section 704(c) allocations with respect to contributed property ("forward" section 704(c) allocations) separately from reverse section 704(c) allocations is great. Consequently, the regulations authorize the IRS to permit, by published guidance or letter ruling, aggregation of QFAs for purposes of making forward section 704(c) allocations.[30]

In Rev. Proc. 2001-36,[31] the IRS exercised its authority under the regulations and granted automatic permission for certain securities partnerships in master-feeder structures to aggregate contributed property for purposes of making section 704(c) allocations.[32] Under current law, master-feeder securities partnerships that satisfy the requirements of Rev. Proc. 2001-36 are the only partnerships that are automatically allowed to aggregate forward and reverse section 704(c) gains and losses.

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built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability).

29 T.D. 8585, 59 Fed. Reg. 66,724 (Dec. 28, 1994).

30 Treas. Reg. § 1.704-3(e)(4)(iii).

31 2001-1 C.B. 1326.

32 Rev. Proc. 2001-36 applies to master-feeder structures in which there is a portfolio of assets that is owned by an entity (the "master fund") that is classified as a partnership for federal tax purposes and that is registered as an investment company under the Investment Company Act of 1940. Each partner of the master fund is an entity (a "feeder fund") that is a regulated investment company for federal tax purposes, or is an investment advisor, principal underwriter, or manager of the portfolio. Rev. Proc. 2001-36, § 2.07, 2001-1 C.B. 1326.

3. Rev. Proc. 2007-59

Recognizing that some of the rules in Treas. Reg. § 1.704-3(e) are unnecessarily restrictive,[33] Treasury and the IRS in 2007 issued Rev. Proc. 2007-59,[34] which provides more flexible rules for aggregating reverse section 704(c) gain and loss from QFAs, but only for "qualifying partnerships." A partnership is a qualifying partnership if it satisfies all of the following six requirements.

1. The partnership's book allocations satisfy the Pro Rata Rule.

2. The partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under the revenue procedure, to make revaluations of QFAs at least four times annually.

3. On the date of each capital account restatement during the taxable year, the partnership satisfies the 90 Percent Test.

4. The partnership reasonably expects, as of the first day of each taxable year for which the partnership seeks to aggregate under the revenue procedure, that the partnership (a) will have at least ten unrelated partners (within the meaning of sections 267(b) or 707(b)) at all times during the taxable year, and (b) will make at least 200 trades of QFAs during the taxable year, the aggregate value of which will comprise at least 50 percent of the book value of the partnership's assets (including cash) as of the first day of the taxable year.

5. The application of the aggregation method to reverse section 704(c) allocations under the revenue procedure is 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.[35]

If a partnership is a qualifying partnership, then the Rev. Proc. provides three advantages. First, the revenue procedure allows all qualifying partnerships (*i.e.*, both

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[33] *See generally Top Firms Comment on Aggregation of Some Reverse Allocations by Securities Partnerships*, 2007 TNT 109-20 (June 6, 2007) (proposal by Deloitte Tax LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP regarding the use of the aggregation methodology for making reverse section 704(c) allocations by securities partnerships).

[34] 2007-2 C.B. 745.

[35] Rev. Proc. 2007-59, § 3.01.

"management companies" and "investment partnerships" meeting the criteria set forth above) to use the more expansive definition of QFAs that, under the regulations, is available only to management companies.[36]

Second, the revenue procedure treats certain lower-tier partnership interests as QFAs. Specifically, a lower-tier partnership interest is a QFA if the interest (i) is traded on an established securities market or readily tradable on a secondary market or the substantial equivalent thereof within the meaning of Treas. Reg. § 1.7704-1(c); or (ii) is an interest in a partnership that represents it is a securities partnership or a qualified partnership, provided that the upper-tier partnership does not actively or materially participate in the management or operations of the lower-tier partnership, and such interest is (A) less than ten percent of the capital and profits of the lower-tier partnership and (B) less than five percent of the total book value of the upper-tier partnership's assets (including cash) as of the first day of the taxable year.[37]

Third, the revenue procedure provides that a qualifying partnership may choose not to aggregate some of the partnership's QFAs, provided that those assets do not exceed in the aggregate 30 percent of the book value of the partnership's non-cash assets at the time any such assets are acquired.[38] This rule allows a qualified partnership to use a layering approach to account for QFAs that are held in "side pockets," the gain or loss from which may not be allocated among the partners in the same proportions as gain or loss from QFAs with respect to which the partnership uses an aggregation method.[39]

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36 *Id.* at § 3.02.

37 *Id.*

38 *Id.* at § 4.01.

39 *See* discussion at Part III.A.2.a. below.

B. Basis Adjustments under Section 734(b) and Section 743(b)

Prior to 2004, partnerships generally were not required (or permitted) to make basis adjustments under section 743(b) or section 734(b) unless they had section 754 elections in effect. As a result of the American Jobs Creation Act of 2004,[40] basis adjustments are mandatory for partnerships with "substantial built-in losses" in the case of section 743(b), and "substantial basis reductions" in the case of section 734(b).[41] Thus, a partnership may be required to make such adjustments even if a section 754 election has not been made.

Section 734(a) provides that the basis of partnership property is not adjusted as the result of a distribution of property to a partner unless an election under section 754 is in effect or there is a substantial basis reduction with respect to the distribution. Section 734(b) provides that if an election under section 754 is in effect or there is a substantial basis reduction with respect to the distribution, the partnership must increase the adjusted basis of partnership property by the amount of any gain recognized by the distributee partner with respect to the distribution, and the amount of any decrease in the adjusted basis of the distributed property, or decrease the adjusted basis of partnership property by the amount of any increase in the adjusted basis of the distributed property.

The regulations under section 755 generally require a basis adjustment under section 734(b) to be allocated among individual items of partnership property based in part on the partnership's share of gain or loss in each asset. Specifically, the regulations under section

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[40] P.L. 108-357, 118 Stat. 1418.

[41] Under section 734(d)(1), there is a substantial basis reduction if a negative adjustment of more than $250,000 would be made to the basis of undistributed partnership property if a section 754 election were in effect at the time of the distribution. Section 743(d)(1) provides that, for purposes of section 743, a partnership has a substantial built-in loss with respect to a transfer of a partnership interest if the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of the property. Exceptions to these rules are provided for "electing investment partnerships" and "securitization partnerships" in section 743(e) and (f), respectively.

755 generally provide that a partnership must allocate a positive basis adjustment under section 734(b) among the partnership's assets of the proper character first in proportion to the unrealized appreciation in those assets, and then in proportion to their fair market values.[42] A partnership generally must allocate a negative basis adjustment under section 734(b) among the partnership's assets of the proper character first in proportion to the unrealized depreciation in those assets, and then in proportion to the partnership's adjusted bases in those assets.[43] The partnership is not permitted to reduce the basis of any item of partnership property below zero.[44]

Section 743(a) provides that the basis of partnership property is not adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner, unless an election under section 754 is in effect or the partnership has a substantial built-in loss immediately after the transfer. Section 743(b) provides that if an election under section 754 is in effect or the partnership has a substantial built-in loss immediately after the transfer, the partnership must increase the adjusted basis of partnership property by the excess of the transferee's basis in its interest over the transferee's share of the partnership's basis in partnership property, or decrease the basis of partnership property by the excess of the transferee's share of the partnership's basis in partnership property over the transferee's basis in its interest.

The regulations under section 755 generally require basis adjustments under section 743(b) to be allocated among individual items of partnership property based in part on

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[42] Treas. Reg. § 1.755-1(c)(2)(ii).

[43] *Id*. Under section 755(c)(1), a partnership is not permitted to allocate a negative basis adjustment under section 734 to stock in a corporation (or any person related, within the meaning of sections 267(b) and 707(b)(1), to such corporation) that is a partner in the partnership. Under section 755(c)(2), any amount not allocable to stock by reason of section 755(c)(1) must be allocated to other partnership property. Gain is recognized to the extent that the amount required to be allocated under section 755(c)(2) to other partnership property exceeds the aggregate adjusted basis of such other property.

[44] Treas. Reg. § 1.755-1(c)(3).

the transferee's share of gain or loss in each asset.[45] Specifically, the regulations under section 755 generally provide that a partnership must allocate a basis adjustment under section 743(b) among the partnership's assets based on the amount of gain or loss that would be allocated to the transferee from each asset if the partnership sold all of its assets for cash in a taxable transaction.[46] Special basis allocation rules apply in the case of "substituted basis exchanges" such as the contribution of a partnership interest to a corporation or to another partnership.[47]

In Rev. Rul. 87-115,[48] and Rev. Rul. 92-15, [49] the IRS ruled that section 743(b) and section 734(b) adjustments, respectively, allocated by an upper-tier partnership to its interest in a lower-tier partnership interest result in an adjustment to the basis of the lower-tier partnership's property if the lower-tier partnership has a section 754 election in effect. In both situations, the adjustment to the basis of the lower-tier partnership's property must be segregated and allocated solely to the upper-tier partnership. Because these rulings were issued long before the enactment of sections 734(d) and 743(d) in 2004, neither ruling addresses the application of these Code provisions to tiered partnerships.

Section 743(d)(2) provides that the Secretary shall prescribe such regulations as may be appropriate or necessary to carry out the purposes of section 743(d)(1) and section 734(d), including regulations aggregating related partnerships and disregarding property acquired

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45 Treas. Reg. § 1.755-1(b).

46 *Id.* After the 1993 Temporary Regulations were promulgated, at least one commentator requested guidance permitting a securities partnership to use an aggregation method to account for section 734(b) adjustments and section 743(b) adjustments, rather than allocating these adjustments to specific assets. *See Deloitte & Touche Asks for Clarification of Partnership Regs*, 94 TNT 57-22 (Mar. 24, 1994). This comment, however, was not adopted when the regulations were finalized. T.D. 8585. Treasury and the IRS also declined to create special rules for securities partnerships when regulations under 734, 743, and 755 were finalized in 1999, stating that such rules were beyond the scope of the project. T.D. 8847, 64 Fed. Reg. 69,903 (Dec. 15, 1999).

47 Treas. Reg. § 1.755-1(b)(5).

48 1987-2 C.B. 163.

49 1992-1 C.B. 215.

by the partnership in an attempt to avoid such purposes.[50] We assume that future guidance will address the application of these rules to tiered partnership structures. For example, in situations in which an upper-tier partnership has a mandatory basis adjustment under section 743(d) or section 734(d), and all or a portion of that basis adjustment is allocated to the upper-tier partnership's interest in the lower-tier partnership, we expect that future guidance will illustrate the extent to which adjustments to the basis of a lower-tier partnership's property are necessary and how those basis adjustments should be allocated among a lower-tier partnership's assets. Thus, under future guidance, a lower-tier partnership may be required to adjust the basis of its property solely as the result of a transfer of an interest in an upper-tier partnership, or a distribution of money or other property by an upper-tier partnership, even if the lower-tier partnership does not have a section 754 election in effect.

II. Principal Recommendations

The principal recommendations of this report are as follows:

Eligibility for Aggregation Method Treas. Reg. § 1.704-3(e)

1. The regulations under section 704(c) should be modified to expand the class of partnerships that are eligible to use an aggregation method to include any partnership for which separately accounting for revaluation gains and losses from QFAs is unduly burdensome, as measured by multiplying (i) the expected number of revaluations over the life of the partnership, (ii) the expected number of assets, and (iii) the expected number of direct and indirect partners (whether related or unrelated).

2. The regulations under section 704(c) should be revised to include the rules in Rev. Proc. 2007-59 that allow certain lower-tier partnership interests to be treated as QFAs and that allow certain QFAs not to be accounted for under the partnership's aggregation method.

[50] *Cf.* section 743(e)(7) (Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of section 743(e), which contains alternative rules for electing investment partnerships, including regulations for applying section 743(e) to tiered partnerships).

3. Future guidance should permit upper-tier partnerships to reasonably determine that a lower-tier partnership is a securities partnership or a qualified partnership based upon available information. In the alternative, future guidance could require lower-tier partnerships to provide any necessary information, and provide appropriate relief to upper-tier partnerships that request, but are unable to obtain such information.

Permitted Revaluation Events Under Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iv)

4. The requirement in Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*)(*iv*) that substantially all of a partnership's assets (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable should be supplemented with a new rule permitting securities partnerships that use an aggregation method for QFAs to revalue at least annually in accordance with accordance with generally accepted industry accounting practices.

Transition Rules

5. If future guidance expanding the availability of an aggregation method for BIG and BIL in QFAs applies only to periods after the date on which the guidance is published or finalized, securities partnerships should be permitted to rely on such guidance for periods preceding that date.

6. Future guidance should allow securities partnerships that do not qualify for aggregation under current law, but qualify under future guidance, to adopt an aggregation method for revaluations occurring after the effective date of the guidance, and should clarify or provide whether there are any other circumstances in which a partnership is permitted to adopt an aggregation method in a taxable year other than its first taxable year.

Technical Issues Under Treas. Reg. § 1.704-3(e)

7. The requirement that a partnership 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) should be clarified to provide that book allocations must be made in proportion to capital only with respect to QFAs that are being accounted for under the partnership's aggregation method.

8. Consideration should be given to issuing guidance clarifying that short positions that are classified as liabilities under Treas. Reg. § 1.752-1 are not QFAs. If short positions are QFAs, and future guidance continues to require a minimum percentage of the partnership's assets to be QFAs, then

we recommend that future guidance illustrate how such positions should be taken into account for purposes of calculating that percentage.

Section 704(c)(1)(C)

9. If a partnership is allowed to use an aggregation method to account for BIG or BIL in contributed property, future guidance generally should allow the partnership to apply that method for purposes of complying with section 704(c)(1)(C). Thus, for example, we recommend that future guidance clarify that partnerships that rely on Rev. Proc. 2001-36 to make 704(c) allocations with respect to contributed property do not need to separately track losses in order to comply with section 704(c)(1)(C).

Basis Adjustments Under Sections 734(b) and 743(b)

10. Future guidance should allow securities partnerships to treat basis adjustments under section 743(b) and section 734(b) that are allocated to QFAs as a separate asset and to recover that adjustment over a time period that is determined under the Projected Turnover Method or one of the alternative methods described below.

11. If future guidance adopts a method of recovering basis adjustments under section 743(b) or 734(b) that involves a factual determination relating to the rate at which the partnership disposes of its assets, then we recommend that the guidance also include an elective safe harbor under which securities partnerships would be permitted to recover basis adjustments over a fixed period (or fixed periods) provided in that guidance.

12. Future guidance should provide rules for determining the source, character, and holding periods of items resulting from the recovery of basis adjustments under section 743(b) or section 734(b) by reference to the source and character of the relevant partnership's other items of income, gain, loss, and deduction.

13. If our recommendation that securities partnerships be allowed to account for basis adjustments under section 743(b) and section 734(b) using an aggregation method is adopted, Treasury and the IRS should consider whether to issue guidance providing that "stuffing" allocations will not be permissible methods for allocating reverse section 704(c) BIG or BIL from QFAs, and should also consider whether such a rule should be prospective in effect.

III. Detailed Discussion

A. Securities Aggregation

The rules of Treas. Reg. § 1.704-3(e) were adequate to cover most securities partnerships when the regulation originally was issued, but the complexity of the marketplace has increased dramatically since that time. As a result, many (and perhaps most) partnerships are not in technical compliance with the regulations or Rev. Proc. 2009-57.[51] For example, many partnerships are not able to satisfy the 90 Percent Test, which applies under both the regulations and Rev. Proc. 2009-57. We believe that the same reasons that motivated the Treasury and the IRS to grant relief to securities partnerships in 1993, 1994, and 2007 support updating the regulations to reflect those market changes. Therefore, we recommend that the regulations under section 704(c) be modified to allow a broader group of partnerships to use an aggregation method. In particular, the 90 Percent Test should be removed and replaced with a new standard that allows aggregation in situations in which accounting for revaluation gain and loss from QFAs separately is unduly burdensome.

We also recommend that the regulations under section 704(c) be revised to include the rules in Rev. Proc. 2007-59 that allow certain lower-tier partnership interests to be treated as QFAs and that allow certain QFAs not to be accounted for under the partnership's aggregation method. Because, in practice, lower-tier partnerships generally are not willing to make the representation required by the revenue procedure, we recommend that future guidance should permit upper-tier partnerships to reasonably determine that a lower-tier partnership is a securities partnership or a qualified partnership based upon available information. In the

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[51] Others have also noted that many taxpayers cannot qualify for relief under Rev. Proc. 2007-59. *See*, *e.g.*, Gina Biondo, Ashley Miller, and Pinchas Schwartz*, Recently Issued Aggregate Method Relief: Rev. Proc. 2007-59 Comes up Short As Disclosure Still Likely for Many Hedge Funds*, 7 J. Tax'n Fin. Products 25 (Apr. 2008) (noting that, notwithstanding the expanded aggregation rules, "many investment partnerships may not satisfy the relief requirements" of Rev. Proc. 2007-59).

alternative, future guidance could require lower-tier partnerships to provide any necessary information, and provide appropriate relief to upper-tier partnerships that request, but are unable to obtain such information in a timely manner.

1. Partnerships Eligible for Securities Aggregation

a. Undue Burden

Rev. Proc. 2007-59 has separate parameters for (i) the number of expected revaluations per year, (ii) the number of expected trades per year, and (iii) the number of unrelated partners. Because the rationale for permitting aggregation is the burden on the partnership, future guidance should not require partnerships to meet each of these parameters separately. Rather, we believe that to determine the burden of accounting for BIG and BIL on a property-by-property basis, future guidance should multiply (i) the expected number of revaluations over the life of the partnership, (ii) the expected number of assets, and (iii) the expected number of direct and indirect partners (whether related or unrelated[52]). For example, a partnership with 8 revaluations, 1,000 assets, and 10 direct and indirect partners generally has a recordkeeping and accounting burden similar to a partnership with 5 revaluations, 2,000 assets, and 8 direct and indirect partners. (This is because 10 x 1,000 x 8 = 80,000, and 5 x 2,000 x 8 = 80,000.) In each case, the partnership's gain or loss is fractured into 80,000 pieces that must be accounted for separately unless aggregation is permitted. To the extent that, taking into account computerized recordkeeping and computational aids, numerous computations are adjudged to be burdensome, (as we have been told is the case), we would recommend that if the product of these

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52 *See* discussion at part III.1.d. below.

three numbers is at least 10,000 with respect to a particular partnership, the partnership should be allowed to use an aggregation method with respect to its QFAs.[53]

This approach, which would focus on the section 704(c) "units of account" or "accounting entries," is consistent with a request for comments that was made in the preamble to the 1993 Temporary Regulations, which first allowed securities partnerships to use an aggregation method for reverse section 704(c) allocations:

> The IRS and Treasury recognize that there are other ways to define a securities partnership. *For example, it is possible to define these partnerships in terms of the number of accounting entries that would be needed on an asset-by-asset method.* The IRS and Treasury welcome comments on how to define a securities partnership.[54]

We note that all allocations under section 704(c) are subject to the general anti-abuse rule of Treas. Reg. § 1.704-3(a)(10) and the specific anti-abuse rules of Treas. Reg. § 704-3(e)(3)(vi), both of which prohibit allocations that are made with a view to reducing the partners' aggregate tax liabilities. Therefore, we recommend choosing a single standard that is based on the burden of accounting for revaluation gains and losses in QFAs on a property-by-property basis. As discussed more fully below, under this approach, it should not be relevant if, in addition to QFAs, the partnership holds other assets with respect to which the partnership does not use an aggregation method, or if the partnership has a particular number of related or unrelated partners.

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[53] This same information could be represented by (i) a table showing the gain or loss in each asset for each period (8,000 entries) and (ii) a table showing the percentage interest of each partner for each period (80 entries). Each partner's share of the appreciation or depreciation in each asset for each period could then be calculated by multiplying the entry in table 1 (asset/period) by the corresponding entry in table 2 (percentage interest of the partner for that period). *See* Stephen Land, *Revaluations Revisited: Partnership Allocations and the Demise of the Ceiling Rule*, Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (Practising Law Institute 2010). Under this approach, each of the 8,000 entries in the first table describes the total BIG or BIL in each asset per period. To apportion that amount among the ten partners, each entry in the first table would be multiplied by the ten percentages in the second table indicating the partners' relative interests in that period. Thus, at the end of each revaluation period, 80,000 entries still would be required to indicate each partner's share of BIG or BIL in each asset.

[54] T.D. 8501, 58 Fed. Reg. 67,684, 67,686 (Dec. 23, 1993) (Emphasis added.)

b. 90 Percent Test

Under both Treas. Reg. § 1.704-3(e) and Rev. Proc. 2007-59, the fair market value of at least 90 percent of the partnership's assets (other than cash) must constitute QFAs. We do not believe the policies supporting aggregation are furthered by this requirement, or by any requirement that would make aggregation for QFAs contingent on any specific minimum percentage of the value of the partnership's assets qualifying as QFAs.[55] Rather, we believe that aggregation should be conditioned on the likelihood that asset-by-asset accounting is unduly burdensome for the partnership.[56]

c. Substantially All Requirement

A similar issue is raised by Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*), which provides that the adjustments must be made principally for a substantial non-tax business purpose in connection with various situations, including "under generally accepted industry accounting practices, provided *substantially all* of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market" (the "Substantially All Requirement").[57] Treas.

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[55] A white paper submitted to Treasury and the IRS in 2007 by Ernst & Young LLP, Deloitte Tax LLP, KPMG LLP, and PricewaterhouseCoopers LLP made the same point. *See Top Firms Comment on Aggregation of Some Reverse Allocations by Securities Partnerships*, 2007 TNT 109-20 (June 6, 2007). Our understanding, based on conversations with government officials involved in drafting Rev. Proc. 2007-59, is that the revenue procedure retains this requirement only because it is found in current Treas. Reg. § 1.704-3(e), and that they were not opposed to removing this requirement from the regulation.

[56] This position is generally consistent with the Tax Section's comments on the 1993 Temporary Regulations. *See NYSBA Recommends Changes in Partnership Aggregation Rules*, 94 TNT 86-15 (May 4, 1994) (New York State Bar Association, Tax Section Report on Treasury Regulations Section 1.704-3T and Certain Other Section 704(c) Matters) ("The real issue is whether the partnership has a sufficient number of securities positions and/or partners that accounting on a partner-by-partner/asset-by-asset basis would be unduly burdensome for the partnership."). *See also Application of Aggregation Rules Needs Clarification, Price Waterhouse Says*, 94 TNT 71-30 (Apr. 13, 1994) ("Alternative tests could define securities partnerships by reference to factors which contribute to the cause for establishing the special aggregation rule: portfolio turnover and partner turnover.").

[57] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(*5*)(*iv*). (Emphasis added.) In the Tax Section's report addressing the proposed regulations, we commented that the proposed regulations should be clarified to permit a partnership to revalue its assets regardless of whether an enumerated event had occurred if the adjustments to partners' capital accounts would reflect each partner's share of assets on distribution. *Report on the Proposed Treasury Regulations*

Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*) does not define the term "substantially all."[58] We do not believe, however, that a securities partnership should be prohibited from revaluing its assets under generally accepted industry accounting practices if it fails to satisfy the Substantially All Requirement. Regardless of tax considerations, securities partnerships must revalue their assets on a regular basis using the best information that is available to the partnership in order to determine the economic entitlements of their partners. (Under generally accepted accounting principles, all investment companies must use mark-to-market accounting.[59]) We recommend that the Substantially All Requirement be supplemented with a new rule permitting securities partnerships that use an aggregation method for QFAs to revalue at least annually in accordance with generally accepted industry accounting practices.

d. Related Partners

As mentioned above, Rev. Proc. 2007-59 requires a qualifying partnership to have at least ten unrelated partners. We do not believe that it should be necessary for the partners to be "unrelated" to qualify for aggregation. Asset-by-asset accounting is unduly burdensome in

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Under Internal Revenue Code Section 704(b), 19 Tax Notes 1123, 1126-27 (June 27, 1983). We noted as an example the "common practice for a partnership engaged in trading listed securities to adjust partners' capital accounts for unrealized gains and losses without regard to whether there has been any contribution, distribution or change in partners' interests." *Id.* at 1126. The final regulations added the situation described in Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*). T.D. 8065, 50 Fed. Reg. 53420 (Dec. 31, 1985).

[58] *See generally* Temp. Treas. Reg. § 1.108(i)-2T(b)(6)(i)(B) (for purposes of determining whether a partnership has disposed of substantially all of its assets within the meaning of section 108(i)(5)(D)(i), substantially all of a partnership's assets means assets representing at least 90 percent of the fair market value of the net assets, and at least 70 percent of the fair market value of the gross assets, held by the partnership immediately prior to the sale, exchange, transfer, or gift); Rev. Proc. 77-37, 1977-2 C.B. 568 ("The 'substantially all' requirement of sections 354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), 368(a)(2)(D), and 368(a)(2)(E)(i) of the Code is satisfied if there is a transfer (and in the case of a surviving corporation under section 368(a)(2)(E)(i), the retention) of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the corporation immediately prior to the transfer.").

[59] FASB Accounting Standard Codification (ASC) 946-10-15-2. For this purpose, an investment company generally is an entity that pools shareholders' funds to provide the shareholders with professional investment management. Typically, an investment company sells its shares to the public, invests the proceeds, mostly in securities, to achieve its investment objectives, and distributes to its shareholders the net income earned on its investments and net gains realized on the sale of its investments. FASB Accounting Standard Codification (ASC) 946-10-05-2.

partnerships in which many of the partners are related, such as family investment partnerships, for the same reasons that separate accounting is unduly burdensome for partnerships in which the partners are unrelated. Under the regulations, partnerships may not make allocations using an aggregation method with a view to reducing substantially the present value of the partners' aggregate tax liability.[60] Moreover, all allocations under Treas. Reg. § 1.704-3 must comply with Treas. Reg. § 1.704-3(a)(10), which provides that the allocations cannot be 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. In addition, securities partnerships are subject to the oversight of their own partners, lenders, and counterparties. Partnerships risk breaching their own partnership agreement and other contractual obligations, including loan agreements, if their asset valuations are not accurate. In light of these considerations, we recommend that the unrelated partner requirement of the revenue procedure not be retained in future guidance.

The definition of a securities partnership in the 1993 Temporary Regulations excluded a partnership that had 50 percent or more of its capital interests held at any time during the current partnership taxable year by five or fewer persons.[61] In response to comments, this requirement was removed because, "[a]fter considering these comments, the IRS and Treasury have determined that a more flexible definition of securities partnership should be adopted."[62]

If future guidance retains a "minimum number of unrelated partners" requirement, then future guidance should clarify that this determination is made on a "look through" basis. This clarification would make aggregation available to master-feeder structures in which indirect

60 Treas. Reg. § 1.704-3(e)(3)(vi).

61 T.D. 8501 58 Fed. Reg. 67,684 (Dec. 23, 1993).

62 T.D. 8585, 59 Fed. Reg. 66,724 (Dec. 28, 1994).

partners hold interests in the master fund through feeder funds and, in many situations, other partnerships. Indeed, in a typical master-feeder structure, there may be as few as three partners (the general partner, and two limited partner feeder funds, one for domestic investors, and one for foreign and tax-exempt investors); however, the master fund often maintains separate revaluation accounts for every indirect investor. Thus, the number of indirect owners/revaluation accounts, rather than the number of direct partners in the master fund, is the relevant number for purposes of assessing the burden of accounting for revaluations on an asset-by-asset basis.

e. Transition Rules

We recommend that, if future guidance expanding the availability of an aggregation method for BIG and BIL in QFAs applies only to periods after the date on which the guidance is published or finalized, securities partnerships be permitted to rely on such guidance for periods preceding that date. We also recommend that future guidance expressly permit securities partnerships that (i) do not literally qualify to use an aggregation method under current law, but (ii) qualify to use an aggregation method under future guidance, will be permitted to adopt an aggregation method for revaluations occurring after the effective date of the guidance.

These transition rules are related to a similar question that arises under current law and that will continue to arise in the future – namely, whether a securities partnership is required to adopt an aggregation method in its first taxable year, or is permitted to adopt an aggregation method in a later year. The answer to this question is unclear under current law.[63]

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[63] On the one hand, under Treas. Reg. § 1.704-3(a)(2), a partnership is permitted to use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a "single reasonable method" for each item of contributed property and that the overall method or combination of methods are reasonable. This language suggests that once a partnership accounts for gains and losses with respect to QFAs, it is bound to continue using that approach (*i.e.*, the "same reasonable method") with respect to those QFAs. Treas. Reg. § 1.704-3(e)(3), on the other hand, provides that "notwithstanding paragraphs (a)(2) and (a)(6)(i) of this section," once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its QFAs for all taxable years in which the partnership qualifies as a securities partnership. This language suggests that a partnership can "adopt" an aggregate approach prospectively, even if it had used a different

Treas. Reg. § 1.704-3(e)(3)(viii), described above, was broad enough to allow partnerships to switch to an aggregation method for revaluations occurring after the effective date of the current rules, but does not literally apply to partnerships that either were formed after that effective date or did not adopt an aggregation method for the first revaluation occurring after that date. We believe that the relevant policy considerations would argue for a flexible approach in permitting a partnership to change to an aggregation method. Accordingly, we recommend that future guidance clarify, or provide, that a securities partnership that qualifies for an aggregation method is not required to adopt such a method in its first taxable year, but is permitted to adopt an aggregation method in a later year.

For example, assume that a securities partnership is formed in 2007 and qualifies for an aggregation method in all taxable years. Because it has a limited number of positions in its first two years, 2008 and 2009, it does not adopt an aggregation method. In 2010, however, the burden of accounting for revaluation gains and losses in QFAs on an asset-by-asset basis becomes excessive. We believe that the partnership should be permitted to adopt an aggregation method for accounting for BIG and BIL in QFAs in 2010 Thus, we recommend that future guidance further provide whether aggregation would be used for gain and loss attributable to prior revaluations, or only for revaluations occurring after the partnership adopts such a method. In addition, we recommend that future guidance provide that switching to an aggregation method in these circumstances does not require consent from the IRS.

method in the past. However, to the extent that previous layers of BIG and BIL in QFAs continue to be accounted for on an asset-by-asset basis after the date on which the partnership adopts an aggregate approach, the partnership arguably would not be using an aggregation approach with respect to "all" of its QFAs.

2. Technical Issues

a. Pro Rata Rule

The current regulations require a securities partnership to make 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).[64] In practice, many, perhaps most, hedge funds maintain "side pocket" investments, the income and loss from which are allocated to the partners who funded the investment. We do not believe that any purpose would be served by applying the Pro Rata Rule to income and losses from assets that are not being accounted for on an aggregation method. Accordingly, we recommend that future guidance clarify that the Pro Rata Rule applies only to book allocations with respect to QFAs that are being accounted for under the partnership's aggregation method, and not to the partnership's other assets.

b. Treatment of Short Positions as QFAs

Treas. Reg. § 1.704-3(e)(3)(ii)(B) specifically includes short positions as QFAs. Under Treas. Reg. § 1.752-1(a)(4)(i)(A) and (ii), however, an obligation under a short sale must be treated as a liability for purposes of section 752 to the extent that the short sale creates or increases the basis of the partnership's assets, including cash.[65] This different treatment (*i.e.*, as an asset under the aggregation regulations and a liability under the section 752 regulations) gives rise to uncertainty regarding the proper accounting for these positions.[66]

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[64] Treas. Reg. § 1.704-3(e)(3)(iii)(A).

[65] The rules in Treas. Reg. § 1.752-1(a)(4)(i)(A) and (ii) are consistent with Rev. Rul. 95-26, 1995-1 C.B. 131, which was published less than four months after the publication of the final aggregation regulations.

[66] The treatment of the short position as a QFA could be critical in determining whether a certain percentage of the partnership's assets are QFAs. For example, assume that an investment partnership (PRS) owns real estate worth $12,000. PRS sells X stock short for $100,000 and uses the cash to buy Y stock worth $100,000. PRS clearly has a section 752 liability of $100,000. If the value of X stock drops to $90,000, and PRS revalues its assets, the short sale contract could be treated as an asset with a fair market value of $10,000 (because PRS received $100,000

We understand that, in practice, the "negative" value of short positions generally is disregarded in determining whether 90 percent of a partnership's assets constitute QFAs. We recommend that Treasury and the IRS consider clarifying that short positions that are classified as liabilities under Treas. Reg. § 1.752-1 are not QFAs. If this recommendation is not adopted, and future guidance continues to require a minimum percentage of the partnership's assets to be QFAs, then we recommend that future guidance illustrate how such positions should be taken into account for purposes of calculating that percentage.

3. Section 704(c)(1)(C)

As mentioned above, in Rev. Proc. 2001-36, the IRS granted automatic permission for certain securities partnerships in master-feeder structures to aggregate contributed property for purposes of making section 704(c) allocations. Under current law, master-feeder partnerships that satisfy the requirements of Rev. Proc. 2001-36 are the only partnerships that are automatically allowed to aggregate forward and reverse section 704(c) gains and losses.

Section 704(c)(1)(C), which was added to the Code in 2004, provides that if any property contributed to the partnership by a partner has a built-in loss, (i) the built-in loss must be taken into account only in determining the amount of items allocated to the contributing partner, and (ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership is treated as being equal to its fair market value at the time of contribution. For these purposes, the term "built-in loss" means the excess of the adjusted basis of the property (determined without regard to clause (ii), above) over its fair market value at the time of contribution.

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in exchange for an obligation to deliver property worth $90,000). In that case, the value of PRS's QFAs would be $110,000, and the percentage of PRS's assets that consists of QFAs would be 90.2 ($110,000 / $122,000). On the other hand, if the revaluation gain is not properly treated as an asset for this purpose, the value of PRS's QFAs would be $100,000, and the percentage of PRS's assets that consists of QFAs would be 89.3 ($100,000 / $112,000).

We believe that if a partnership is allowed to use an aggregation method to account for BIG or BIL in contributed property, future guidance generally should allow the partnership to apply that method for purposes of complying with section 704(c)(1)(C).[67] Without such a rule, if a partner contributes some properties with BIG, and other properties with BIL, aggregation only will be permitted for the appreciated property. All of the depreciated properties will be subject to section 704(c)(1)(C), and the BIL in those properties apparently would need to be accounted for on a property-by-property basis. Thus, for example, future guidance should clarify that partnerships that rely on Rev. Proc. 2001-36 to make 704(c) allocations with respect to contributed property do not need to separately track losses in order to comply with section 704(c)(1)(C).[68] Any allocations of BIL in contributed property that are made using an aggregation method would continue to be subject to the anti-abuse rule of Treas. Reg. § 1.704-3(a)(10) and the requirements of Treas. Reg. § 1.704-3(e)(3)(vi).

B. Basis Adjustments under Section 734(b) and Section 743(b)

Securities partnerships generally do not make section 754 elections, even when basis increases under sections 743(b) and 734(b) would reduce the tax liabilities of their partners, because of the undue burden of allocating the adjustments among hundreds or thousands of assets and accounting for those adjustments. As noted above, however, basis adjustments are mandatory for partnerships with "substantial basis reductions" in the case of section 734(b), and

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[67] Several letter rulings have permitted aggregation of BIG and BIL with respect to contributed property that were issued after the enactment of section 704(c)(1)(C). *See* PLR 200633019 (Apr. 19, 2006); PLR 201028016 (Mar. 25, 2010); PLR 201028017 (Mar. 25, 2010); PLR 201032003 (Apr. 21, 2010). Each ruling states that the ruling is limited to allocations of gain or loss from the sale or other disposition of qualified financial assets made under section 704(b) and 704(c)(1)(A), and Treas. Reg. § 1.704-3(a)(6); none of the rulings mentions section 704(c)(1)(C).

[68] *See also* Treas. Reg. § 1.704-3(e)(2) (permitting aggregation, for purposes of section 704(c)(1)(A), of (i) depreciable property, other than real property, in the same general asset account of the contributing partner and the partnership under section 168, (ii) property with a basis of zero, other than real property, and (iii) for partnerships that do not use a specific identification method of accounting items of inventory other than qualified financial assets); Treas. Reg. § 1.704-3(e)(4) (IRS may permit aggregation by published guidance or by letter ruling).

"substantial built-in losses" in the case of section 743(b). Thus, partnerships may be required to make such adjustments even if a section 754 election has not been made.

We recommend that Treasury and the IRS issue guidance that would illustrate permissible methods for applying sections 734(b) and 743(b) of the Code to partnerships using the special aggregation rules under Treas. Reg. § 1.704-3(e). As discussed below, we recommend that this guidance include special rules permitting the basis adjustments to be treated as separate assets for purposes of section 755, as well as rules for determining when the basis adjustments are taken into account, and the source, character, and holding period of the items of income or loss arising from those adjustments.[69]

1. Basis Adjustments under Section 734(b)

a. Treatment as a Separate Asset

As described above, the current regulations under section 755 generally provide that a partnership must allocate a basis adjustment under section 734(b) among the partnership's assets of the proper character based on the amount of gain or loss in assets of the proper character.[70] Partnerships that use an aggregation method under Treas. Reg. § 1.704-3, however, often have many assets and high turnover. For many of the same reasons that making section 704(c) allocations is unduly burdensome, the process of allocating basis adjustments to particular assets under section 755 can be unduly burdensome if the partnership has hundreds or thousands of assets, directly or indirectly through lower-tier partnerships.[71] For this reason, we recommend that future guidance provide that securities partnerships may treat a section 734(b) basis adjustment as a separate asset to the extent that adjustment is allocated to QFAs with respect to

[69] The following discussion is limited to basis adjustments that would be allocated to QFAs that are being aggregated for purposes of making reverse section 704(c) allocations. To the extent that a basis adjustment is allocated to other assets under section 755, the normal rules would apply.

which the partnership uses an aggregation method, and that the adjustment may be recovered over a time period that is determined using a reasonable method.

b. Recovery Period of Basis Adjustment

If a section 734(b) adjustment were treated as a separate asset, there are a number of possible methods for recovering that basis adjustment over time. This section discusses four potential methods – the Projected Turnover Method, the Actual Turnover Method, the Basis First Method, and the Fixed Period Method. Other methods are possible.[72]

First, partnerships could be required to recover basis adjustments attributable to QFAs over a predetermined period based on the rate at which the partnership historically has sold (or expects to sell) its QFAs (the "Projected Turnover Method"). Under this approach, a partnership would be required to determine its historic or projected turnover period reasonably and in good faith. If a particular partnership, for example, reasonably determines in good faith that it has sold one half of its QFAs (by fair market value) in each of its two most recent taxable

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[70] Treas. Reg. § 1.755-1(c). The impact of distributions, including basis adjustments under section 734(b), on reverse section 704(c) allocations in partnerships that do not use an aggregation method has been discussed extensively by other commentators. *See*, *e.g.*, Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 Tax Law. 343 (Winter 2004); Karen C. Burke, *Repairing Inside Basis Adjustments*, 58 Tax Law. 639 (Spring 2005).

[71] After the 1993 Temporary Regulations were promulgated, at least one commentator requested guidance permitting a securities partnership to use an aggregation method to account for section 734(b) adjustments and section 743(b) adjustments, rather than allocating these adjustments to specific assets. *See Deloitte & Touche Asks for Clarification of Partnership Regs*, 94 TNT 57-22 (Mar. 24, 1994). This comment, however, was not adopted when the regulations were finalized. T.D. 8585. Another commentator requested similar relief in response to proposed regulations under 734, 743, and 755, but the Treasury and the IRS again declined to provide such rules at that time. *See Accountant Suggests Change to Proposed Regs on Partnership Basis*, 98 TNT 118-21 (June 19, 1998) (letter from Moshe Metzger); T.D. 8847, 64 Fed. Reg. 69,903 (Dec. 15, 1999) ("One commentator suggested that the regulations permit securities partnerships to allocate basis adjustments among partnership assets using an aggregation method.... The IRS and the Treasury Department believe that a method for allocating basis adjustments among partnership assets on an aggregate basis is not consistent with the hypothetical sale of individual assets, which is required by the regulations."). For the reasons discussed in this report, however, we believe that allowing securities partnership to account for basis adjustments under a simplified method in appropriate situations is consistent with the policies of sections 734, 743, and 755, which do not expressly require an allocation of basis adjustments to particular assets in situations in which doing so would be unduly burdensome.

[72] For example, another possible method was described in a letter commenting on the proposed regulations under sections 734, 743, and 755. *Accountant Suggests Change to Proposed Regs on Partnership Basis*, 98 TNT 118-21 (June 19, 1998) (letter from Moshe Metzger).

years (including the year in which the basis adjustment arose), the partnership could recover basis adjustments attributable to QFAs ratably over a two-year period.[73] Consider the following example:

> ***Example 1***. A securities partnership (SP) is formed on January 1, 2010 and has a taxable year ending on December 31. SP uses the full netting method under Treas. Reg. § 1.704-3(e). SP's average turnover rate for 2010 and 2011 is 50 percent (by fair market value) per year. On June 30, 2012, X receives a distribution from SP, resulting in a positive basis adjustment of $100 under section 734(b).
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> Under the Projected Turnover Method, the basis adjustment would be recovered ratably over a 24-month period beginning on July 1, 2012. Thus, $24 of the adjustment would be recovered in 2012, $48 of the adjustment would be recovered in 2013, and $24 of the adjustment would be recovered in 2014.

For a partnership that has not been existence long enough to establish a turnover rate, future guidance could allow a partnership to recover basis adjustments over the period over which it reasonably and in good faith expects to turn over all of its property.[74] Future guidance also could allow a partnership to use, in determining its turnover period, a projected turnover period or rate that the partnership has disclosed to potential investors.

The determination of a partnership's turnover period could be complicated in tiered partnership structures. For example, an upper-tier partnership may invest in multiple

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[73] Portfolio turnover is a measure of how often a fund buys and sells assets. For example, a partnership with a turnover of 100 percent holds its assets for an average of one year. A partnership with a turnover of 50 percent holds its assets for an average of two years. Turnover can be calculated as the value of all purchases and sales, divided by two, divided by the average fair market value of the partnership's assets (*i.e.*, the partnership counts one asset sold, and another one bought, as one "turnover"). Another method of measuring turnover is to divide (i) the lesser of proceeds from assets sold or cost of securities purchased, by (ii) the average fair market value of the partnership's assets.

[74] In this regard, future guidance could include a safe harbor under which a partnership is permitted to use its "lock-up" period as a proxy for its expected turnover period. A lock-up period is a period of time during which investors in a hedge fund or other partnership may not compel the partnership to redeem their interests. The lock-up period allows portfolio managers to identify and purchase the partnership's investments without being forced to sell those investments in order to redeem partners. The lock-up period generally corresponds to the amount of time that the portfolio manager will need to fully deploy the partnership's capital, taking into account the partnership's investment objectives. In general, funds with longer turnover periods tend to have longer lock-up periods.

lower-tier partnerships, each of which has a different turnover period. In these cases, we recommend that future guidance permit the upper-tier partnership to recover basis adjustments in a manner that takes into account the turnover periods of the lower-tier partnerships.[75] If, under the normal rules, a basis adjustment would have been allocated to an interest in a lower-tier partnership that uses a mark-to-market method of accounting for some or all of its assets, then an appropriate portion of the basis adjustment that would have been allocated to such an interest presumably would be recovered in the year in which the adjustment is made. Any remaining adjustment would be determined using the Projected Turnover Method. These principles are demonstrated by the following example.

> ***Example 2***. The only assets of a partnership (UTP) are interests in three lower-tier partnerships (LTP1, LTP2, and LTP3). LTP1 marks all its assets to market under section 475, but LTP2 and LTP3 do not. In 2011, UTP is required to make a basis adjustment under section 734(b) of $5 million.
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> Under current Treas. Reg. §1.755-1(c), the basis adjustment would be allocated $1 million to UTP's interest in LTP1, $1 million to UTP's interest in LTP2, and $3 million to UTP's interest in LTP3. The $1 million of the adjustment that would have been allocated to LTP1, which marks all of its assets to market, would be recovered in 2011, and the portions of the basis adjustment allocated to the assets of LTP2 and LTP3 would be recovered when those assets were actually sold.
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> The application of the Projected Turnover Method would change this result in part. The $1 million of the adjustment that would have been allocated to LTP1, which marks all of its assets to market, would still be recovered in 2011. But, assuming that the average turnover rate in LTP2 is 2 years, and the average turnover rate for LTP 3 is three years, future guidance could require UTP to recover one-fourth of the remaining adjustment, or $1 million, using the turnover period of LTP2 (two years), and 3/4 of the remaining adjustment, or $3 million using the turnover period of LTP3 (three years). Alternatively, future guidance could permit UTP to recover the remaining adjustment of $4 million using a weighted

[75] This approach simulates the effects of requiring the lower-tier partnerships to adjust the basis of their properties, without actually requiring the lower-tier partnerships to maintain and report the actual basis adjustments. If this approach were adopted, then each of the lower-tier partnerships generally would need to report its turnover period to the upper-tier partnership.

average rate of 2.75 years (1/4 times two years, plus 3/4 times three years).[76]

Second, partnerships could be required to recover basis adjustments under section 734(b) based on the rate that the partnership actually sells the assets owned on the date of the transfer (the "Actual Turnover Method"). Thus, each time that an asset that was owned on the date of transfer is later sold, the portion of the section 734(b) adjustment recovered would be determined by multiplying the total remaining adjustments by a fraction, the numerator of which would be the fair market value of the sold asset on the date of transfer, and the denominator of which would be the total fair market value of all partnership assets on the date of the transfer. This method would be more cumbersome than any of the three methods described above. Moreover, this method would be very difficult to implement in tiered partnership structures.

Third, basis adjustments could be recovered, dollar for dollar, every time the partnership recognizes gain (in the case of a positive adjustment) or loss (in the case of a negative adjustment) that is attributable to QFAs (the "Basis First Method"). Thus, positive basis adjustments would offset gains from sales or exchanges of QFAs, and negative basis adjustments would offset losses from sales or exchanges of QFAs, dollar for dollar, until the basis adjustments have been exhausted.[77] The Basis First Method is illustrated by the following example.

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[76] If, in addition to its investments in lower-tier partnerships, the upper-tier partnership invests directly in QFAs, its direct investments could be treated in the same way as an investment in a lower-tier partnership for purposes of determining the proper recovery period. For example, assume that in Example 4, UTP did not own an interest in LTP2, but invests directly in QFAs. If $1 million of the adjustment would have been allocated to the QFAs held directly by UTP under Treas. Reg. § 1.755-1(c), then future guidance could allow UTP to recover this portion of the adjustment using the turnover period for those QFAs, or to use that period in calculating a weighted average rate.

[77] As discussed below in section III.B.2, these same methods could be used for basis adjustments under section 743(b), which result from transfers of partnership interests. In the case of a negative section 743(b) adjustment, the effect of applying the Basis First Method to transferees of interests in securities partnerships would be similar to the effect of applying the partner-level loss disallowance rules of electing investment partnerships

> ***Example 3***. On January 1, 2011, X receives a distribution from a securities partnership (SP) that uses the full netting method under Treas. Reg. § 1.704-3(e), resulting in a positive basis adjustment of $100 under section 734(b). SP recognizes $120 of gain from QFAs in 2011. Under the Basis First Method, the entire $100 adjustment would be recovered in 2011, reducing SP's income for 2011 to $20. No portion of the adjustment would remain in 2012. Under the normal rules, (i) the basis adjustment would have been allocated to specific assets held by SP on January 1, 2011, (ii) SP would have recovered in 2011 only the portion of the basis adjustment that was allocated to those assets that were sold or exchanged before the end of 2011, and (iii) SP would have recovered the remaining portion of the adjustment as the remaining assets were sold or exchanged in later years.

There are some cases in which the Basis First Method could be less advantageous to securities partnerships than allocating the basis adjustment to specific assets under the normal rules. Nevertheless, as Example 3 demonstrates, the Basis First Method often would be more advantageous (in the case of positive basis adjustments) than the normal rules.

Finally, partnerships could be required to recover basis adjustments attributable to QFAs ratably over a fixed period, such as three years (the "Fixed Period Method").[78] This approach would have the benefit of being easy to administer for both taxpayers and the IRS. The Fixed Period Method, however, would be rather arbitrary.

Of the four methods described above, the Actual Turnover Method would be the most accurate of the four methods in matching the timing that would have resulted from allocating the basis adjustment to specific assets under the normal rules. It also would be the most administratively burdensome of those four methods. The Basis First Method and the Fixed Period Method are the least accurate, because they are not directly tied to the rate at which a

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under section 743(e). *See* Notice 2005-32, 2005-1 C.B. 895 (providing interim procedures for taxpayers to comply with sections 734(d), 743(d), and 743(e)).

[78] Although we do not recommend it, future guidance similarly could require different recovery periods or methods for positive and negative basis adjustments that are allocated to QFAs with respect to which a securities partnership uses an aggregation method. *Cf.* Rev. Proc. 2008-52, 2008-2 C.B. 587, § 5.04(1) (providing, in some situations, for a four year recovery period for net positive section 481 adjustments, and a one year recovery period for net negative section 481 adjustments, resulting from a change in a taxpayer's method of accounting).

particular partnership disposes of its assets. We believe that the Projected Turnover Method would result in tax consequences that approach those that would have resulted under the normal rules, without imposing an undue burden on securities partnerships and, for that reason, recommend that future guidance require securities partnerships to recover basis adjustments using this method.

c. Source, Character, and Holding Period

If a basis adjustment under section 743(b) were treated as a separate asset, it would be necessary to make certain assumptions regarding the source and character of the gain or loss that results from the recovery of the basis adjustment under section 743(b), such as whether the gain or loss is treated as arising from the sale of a capital asset. To address these issues, future guidance could provide that any gain or loss that is recognized from the recovery of a basis adjustment would be characterized as U.S.-source income, gain, or loss, and as ordinary or capital, in the same proportions as the partnership's overall gains and losses for the taxable year in which the adjustment arose.

The portion of the adjustment characterized as capital gain or loss could be further pro-rated between long-term and short-term capital gains and losses depending on when the adjustment is recovered. Thus, for example, to the extent the adjustment treated as capital is recovered in the year in which the adjustment arose, the adjustment could be pro-rated between long-term and short-term in proportion to the partnership's long-term and short-term capital gains and losses for that year. With respect to the portion of the adjustment treated as capital that is recovered in subsequent taxable years, a number of options are available. For example, the adjustment could be pro-rated between long-term and short-term gains and losses in the same proportions as in the year in which the adjustment arose, or it could be treated as entirely long-

term capital gain or loss on the theory that if the basis adjustment had been allocated to capital assets, and those assets were sold more than 12 months after they were acquired, the partnership's gain or loss would have been long-term capital gain or loss.

d. Interaction With Stuffing Allocations

Partnership agreements for securities partnerships typically provide the general partner with the authority (but not the obligation) to specially allocate to a withdrawing partner taxable gain or loss from the sale of QFAs (to the extent available) in an amount equal to the partner's share of the unrealized gain or loss in QFAs held by the partnership. In the case of a cash distribution, these allocations correspond to the withdrawing partner's share of gain or loss as reflected in the revaluation account that is maintained for that partner for the purpose of accounting for reverse section 704(c) gain or loss from QFAs under Treas. Reg. § 1.704-3(e). These allocations commonly are referred to as "stuffing," or "fill-up" and "fill-down," allocations.[79] Stuffing allocations are nearly universal among securities partnerships when partners are completely redeemed.[80] Stuffing allocations are controversial, however, and this report does not address the efficacy of stuffing allocations under current law.[81]

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[79] Stuffing allocations in securities partnerships cannot qualify under the "substantial economic effect" standards of the section 704(b) regulations because they are allocations of tax items, not book items. In other contexts, special allocations of section 704(b) income or loss to a withdrawing partner also may be described as "stuffing" allocations. For example, a partnership may dispose of appreciated property in a like-kind exchange under section 1031, receiving a combination of cash and other property. If all of the "boot" is distributed to one partner in liquidation of its interest, the partnership may allocate any gain recognized from the exchange to that partner. *See generally* Terrence Cuff, *Proposed Regulations Try – Unsuccessfully – to Fix a Broken Set of Substantiality Rules*, 104 J. Tax'n 280 (May 2006); Karen T. Lohnes, John Schmalz, and Craig Gerson, *Value Equals Basis and Partners' Distributive Share: Stuffing, Fill-Ups, and Waterfalls*, 105 J. Tax'n 109 (Aug. 2006). Stuffing allocations of section 704(b) income raise issues that are beyond the scope of this report.

[80] Some, but not all, securities partnerships use stuffing allocations in the case of distributions that do not completely liquidate the distributee's interest. Additionally, some partnerships make stuffing allocations from the partnership's items of net income or loss, while other partnerships make stuffing allocations from the partnership's items of gross income or loss.

[81] *See generally* Brian E. Ladin, James M. Lowy, and William S. Woods II, *Hedge Fund Stuffing Allocations: A Path Through the Maze*, 2008 TNT 228-34 (Nov. 25, 2008) (arguing that stuffing allocations are permitted under

By causing the distributee partner's adjusted basis in its interest ("outside basis") to equal the amount of cash the distributee will receive, a stuffing allocation prevents the distributee partner from recognizing a gain or loss under section 731(a).[82] Consequently, the distribution will not result in a basis adjustment under section 734(b).[83] These points are illustrated by the following example.

> ***Example 4***. A calendar-year securities partnership (SP) that owns only QFAs uses the full netting approach under Treas. Reg. § 1.704-3(e)(3)(v). On December 31, 2010, SP distributes $1 million in cash to partner A in liquidation of A's interest. A's adjusted basis on December 31, 2009, was $600,000. Immediately before the distribution, SP revalues its property under Treas. Reg. § 1.704-1(b)(2)(iv)(*f*). After the revaluation, A's revaluation account, representing A's share of the net appreciation and depreciation in the SP's assets, is $400,000. In 2010, SP recognizes $10 million of capital gain (and no other items of income or loss). Assume that if a stuffing allocation is not made, A would be allocated $100,000 of SP's capital gain in 2010. SP does not have an election under section 754 in effect.
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> *Results without stuffing allocation*. If SP were to allocate $100,000 of capital gain to A, A's outside basis would increase from $600,000 to $700,000, and the amount in A's revaluation account would be reduced to $300,000. A would recognize an additional $300,000 capital gain under section 731(a) (the excess of the $1 million cash distribution over A's $700,000 outside basis immediately before the distribution), SP would not be permitted to make a positive section 734(b) adjustment of $300,000 to its capital assets because SP does not have an election under section 754 in effect.
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> *Results with stuffing allocation*. If, instead, SP were to make a stuffing allocation of $400,000 of capital gain to A, then A's outside basis would be increased to $1 million, A's revaluation account would be reduced to $0, and A would not recognize any additional gain from the distribution of $1 million of cash. The

current law); *Writer Differs with Hedge Fund Stuffing Report Conclusion*, 2008 TNT 237-34 (letter from Andrew W. Needham arguing that stuffing allocations are not permitted under current law).

[82] In the absence of a stuffing allocation, a withdrawing partner could recognize gain under section 731(a). This gain generally would equal the amount in the partner's revaluation account. If the partnership had a section 754 election in effect, the partnership's gain in its remaining assets would be reduced by the same amount under section 734(b). Securities partnerships, however, generally do not make section 754 elections.

[83] These results are conditioned on the securities partnership having sufficient tax items to eliminate the difference between the distributee partner's outside basis and the amount of cash to be distributed to the partner in liquidation of its interest. In practice, securities partnerships typically treat all items arising in the taxable year of the distribution as being available to make stuffing allocations.

> capital gain allocated to the continuing partners of SP in 2010 would be decreased by $300,000 as a result of the stuffing allocation (because A was allocated $400,000 of gain rather than $100,000 of gain).

In Example 4, the amount and timing of A's income is not affected by the stuffing allocation -- A recognizes a total of $400,000 of gain in either case. Specifically, without the stuffing allocation, A is allocated $100,000 of gains and recognizes $300,000 of gain under section 731(a); with the stuffing allocation, A is allocated $400,000 of gains and does not recognize any gain under section 731(a).

The continuing partners, however, would prefer to make the stuffing allocation, because the stuffing allocation reduces their taxable income by $300,000 in 2010 and prevents a disparity from arising between SP's aggregate adjusted basis in SP's assets and the continuing partners' aggregate outside basis in their partnership interests. If a stuffing allocation is not made, the distribution to A would cause a disparity between SP's aggregate adjusted basis in SP's assets and the continuing partners' aggregate outside basis. A's share of the unrealized gain in SP's property, $300,000, would be allocated to the continuing partners as that property is sold over time. When the interests of the continuing partners eventually are sold or redeemed, the continuing partners will recognize an aggregate loss of $300,000.

This inside/outside basis disparity could be avoided if SP had a section 754 election in effect. In that case, if no stuffing allocation were made, then, under the normal rules, SP would be entitled to a $300,000 positive basis adjustment under section 734(b). This basis adjustment would be allocated among SP's assets and recovered over time as the assets held by SP on July 1, 2010 are sold or exchanged.

Because a stuffing allocation occurs in the taxable year of the distribution, however, it generally is more favorable to the continuing partners than a section 734(b)

adjustment, which typically is recovered more slowly. For example, if SP were to sell half of those assets in 2011, and half of those assets in 2012, the basis adjustment would be completely recovered by the end of 2012. Over a two year period, the taxable income allocated to SP's remaining partners would be reduced (or the taxable losses allocated to those partners would be increased) by $300,000. Complex recordkeeping, however, would be required to allocate the section 734(b) adjustment among SP's assets and recover small portions of that adjustment as each asset was sold. For this reason, as described above, securities partnerships generally do not make elections under section 754.

The Executive Committee of the Tax Section was divided concerning whether, if our recommendation that securities partnerships be allowed to account for basis adjustments under section 734(b) and section 743(b) using an aggregation method is adopted, future guidance should provide that stuffing allocations will not be a permissible method for allocating reverse section 704(c) BIG or BIL from QFAs. Some members of the Executive Committee believe that future guidance should provide that stuffing allocations will not be a permissible method. Other members of the Executive Committee believe that future guidance need not address stuffing allocations. We note, however, that, without such a rule, it is unlikely that an eligible partnership would be motivated to elect the proposed basis adjustment regime.

2. Basis Adjustments under Section 743(b)

The consequences of a basis adjustment under section 743(b) generally are more complicated than the consequences of a basis adjustment under section 734(b). Whereas a basis adjustment under section 734(b) is made to the common basis of partnership property, a basis adjustment under section 743(b) is personal to the transferee. We recommend that future guidance generally provide that the methods for recovering basis adjustments under section

743(b), and for determining the source, character, and holding periods of gain or loss resulting from those adjustments, be the same methods that future guidance provides for basis adjustments under section 734(b).[84]

Normal rules under section 743 and 755 generally would continue to apply to BIG and BIL with respect to contributed property. Accordingly, to the extent that a transferee's basis adjustment is attributable, in whole or in part, to forward section 704(c) gain or loss (*i.e.*, from an actual contribution of property to the partnership by the transferor (or its predecessor)), the proposed aggregation method generally would not be available. Thus, any part of the transferee's basis adjustment that is allocated to contributed property would be taken into account when that asset is sold, depreciated, or amortized under the normal rules.[85] Partnerships that are allowed to use an aggregation method for forward section 704(c) gain or loss, however, presumably would be allowed to use the methods prescribed in future guidance for allocating and recovering basis adjustments under section 743(b), as described above.

3. Transition Rule

Many securities partnerships have partnership agreements reflecting two key assumptions: the partnership will not make a section 754 election, and the partnership will use stuffing allocations. Thus, some partnership agreements may prohibit the partnership from making a section 754 election and/or require the partnership to make stuffing allocations. If

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[84] One modification would be necessary in the case of the Basis First Method. Because a section 743(b) adjustment is personal to the transferee of a partnership interest, only the transferee's share of income or loss would be taken into account in applying the Basis First Method to basis adjustments under section 743(b).

[85] In Notice 2009-70, 2009-34 I.R.B. 255, Treasury and the IRS requested comments on the proper application of the rules relating to the creation and maintenance of multiple layers of forward and reverse section 704(c) gain and loss to partnerships and tiered partnerships. Although guidance on how partnerships should account for multiple layers of section 704(c) gain or loss would be helpful, these issues need not be resolved to address the issues raised by this report, nor would it be necessary for the guidance requested in this report to address those issues. For a detailed discussion, *see* NYSBA Tax Section Comments on Treatment of Layers in Partnership Mergers, Divisions, and Tiered Partnerships, 2010 TNT 16-22 (Jan. 26, 2010) (New York State Bar Association, Tax Section Report No. 1202, Report on the Request for Comments on Section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships).

Treasury and the IRS accept our recommendation to allow aggregating partnerships to account for basis adjustments under section 743(b) and section 734(b) using an aggregation method, then, depending on whether stuffing allocations are permitted under that regime (as discussed above), we believe that many or at least some such partnerships likely would wish to make an election under section 754. These changes, however, often would require the partnership to obtain consent from its partners and/or to amend its partnership agreement.

Accordingly, we recommend that future guidance include transition rules for partnerships formed prior to the date on which final regulations or other guidance becomes effective ("existing partnerships"). For example, the transition rules could provide that the new guidance will apply to existing partnerships one year after the date on which such guidance otherwise becomes effective and that, prior to this delayed effective date, the IRS will not challenge reasonable methods of accounting for reverse section 704(c) gains and losses (which might include stuffing allocations made consistently with respect to both gains and losses), provided that the partnership's allocations under those methods were not made with a view to shifting the tax consequences of BIG or BIL among the partners in a manner that substantially reduces the partners' aggregate federal income tax liability). In addition, we recommend that future guidance provide that existing partnerships will be permitted to rely on that guidance regardless of their prior methods of accounting for reverse section 704(c) gains and losses.

4. Conclusion

Just as it is unduly burdensome for many securities partnerships to make reverse section 704(c) allocations on a property-by-property basis, it is unduly burdensome for many securities partnerships to make basis adjustments under sections 734(b) and 743(b) on an asset-by-asset basis. Accordingly, we believe that the reasons for allowing securities partnerships to

use an aggregation method to account for reverse section 704(c) allocations also justify allowing these partnerships to use an aggregation method under sections 743 and 734. For the reasons set forth above, we recommend that future guidance allow securities partnerships using an aggregation method to account for reverse section 704(c) allocations also to account for basis adjustments under sections 743(b) and 734(b) using an aggregation method. Rather than being allocated to specific assets, the basis adjustments could be recovered under the Projected Turnover Method or one of the alternative methods described above.

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