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TAX PLANNING ISSUES FOR HEDGE FUND PARTNERSHIP MERGERS

In addition to the usual concerns that arise in the proposed merger of two partnerships, special factors affect the combination of hedge funds. While there are structural solutions that may avoid the most common problems without any impact on the economics of the transaction, care must be taken in determining both the direction and form of the merger.

With the continuing economic downturn, hedge fund mergers [FN1] are on the rise. Unaffiliated funds are looking for synergistic opportunities to pool assets under management while reducing expenses. [FN2] Likewise, investment advisors with numerous funds employing similar strategies are often considering merging those funds in order to save on audit and compliance fees associated with the maintenance of separate funds.

While fund mergers can provide significant cost savings, structuring such mergers also can raise several potential tax issues. An exhaustive analysis of all potential tax issues in fund mergers would be impossible given the unique considerations of different funds and transactions, and the wide range of investment and trading activities conducted by hedge funds. Nevertheless, some common issues arise in connection with the structuring of combinations of funds organized as partnerships for federal income tax purposes. [FN3] The primary structural tax concerns in such mergers generally arise under the partnership merger rules set forth in Reg. 1.708-1(c) , and broadly relate to (1) the direction of the merger and (2) the form of the merger. [FN4] There also is a potential issue of gain recognition on the merger, under Section 721(b).

DIRECTION OF THE MERGER

Unlike a merger of two corporations, merging partnerships are not entitled to choose the direction of their merger for federal income tax purposes. Instead, the Regulations provide mechanical tests for determining which entity is the ‘merged‘ entity and which is the ‘survivor.‘ This may or may not comport with the state-law direction of a merger.

Reg. 1.708-1(c)(1) provides that where two partnerships merge or consolidate into one partnership, ‘the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a continuation of more than one of the merging or consolidating partnerships, it shall, unless the Commissioner permits otherwise, be considered the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated.‘

Reg. 1.708-1(c)(5), Example 2 , makes clear that this general rule will supersede the direction chosen for purposes of state law. The example postulates two partnerships, X and Y. Both are owned 60% by partner B. X has net assets worth $100x and Y has net assets worth $200x. Under state law, Y merges into X by contributing its assets and liabilities to X in exchange for interests in X, and then liquidating, distributing interests in partnership X to partnership Y's partners, B

and C. The example states that because B owned more than 50% of the profits and capital of both partnerships before the merger, the ‘surviving partnership‘ will be the one with the larger net asset value immediately prior to the merger.

Because Y had a larger net asset value, it will be the ‘surviving partnership‘ for federal income tax purposes, and the direction of the merger selected for state law will be reversed. X will be deemed to have contributed its assets and liabilities to Y in exchange for interests in Y and to have liquidated, distributing interests in Y to the partners of X. The resulting partnership will have the same employer identification number (EIN) as partnership Y. More important, all elections in effect for partnership Y will remain in effect for the surviving partnership—even though for all state law purposes, X was the surviving partnership. [FN5]

To those practitioners versed in corporate mergers and acquisitions, this rule governing the direction of partnership mergers will appear anathema, as the direction of a corporate merger or consolidation is determined by the taxpayer (and has substantial tax implications). [FN6] The partnership merger rules thus represent a potential trap that can have significant consequences. Issues that may be implicated in the determination of the deemed direction of a hedge fund merger are (1) the tax elections that may be in place for the merged entity and, less frequently, (2) the status of ‘grandfathered short sales against the box.‘

Elections

While it has been widely noted that the Code provides for hundreds of tax elections, [FN7] the two most important elections commonly made by hedge funds are (1) the Section 475(f) election and (2) the Section 754 election. To the extent that either election unintentionally remains in effect or is unintentionally terminated for a merged entity, the consequences could be significant.

475(f) election. Under Code Section 475, ‘dealers‘ in securities or commodities are required to account for those assets by recognizing gain or loss on the unrealized appreciation or depreciation in the securities or commodities on an annual basis. Under Section 475(f), a ‘trader‘ in securities or commodities *may* elect to have this mark-to-market rule apply as well.

The determination of whether a hedge fund is a ‘trader‘ for federal income tax purposes is based on the facts and circumstances, including the number of trades and frequency of trading. [FN8] If a fund elects to have Section 475 apply, all of its unrealized appreciation or depreciation in securities or commodities will be recognized for federal income tax purposes as ordinary income or loss on an annual basis (and basis will be thereafter adjusted for such gains or losses). [FN9]

Once made, an election under Section 475(f) may not be revoked without IRS consent. [FN10] It would thus appear that even if a fund ceases to qualify as a trader in securities eligible to make the election, an election that already has been made will continue in effect. Nothing in the Code or Regulations, however, addresses this possibility. [FN11]

If a Section 475(f) election is in effect, the loss deferral rules of Section 1092, the wash-sale rules of Section 1091, and the constructive sale rules of Section 1259 will not apply to limit the losses or accelerate the gains of the fund. Moreover, the ‘excess distribution‘ regime governing investments in passive foreign investment companies (PFICs) will not apply. Thus, a fund holding securities of foreign corporations that are PFICs may use a Section 475(f) election as part of its planning for such investments. [FN12]

Accordingly, there are very particular circumstances that might cause a fund to make an election under Section 475(f). These include:

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- The expectation of early period losses permitting front-loading of ordinary losses.
- Heavy investment in PFICs for which QEF elections cannot be made.
- Rapid portfolio turnover giving rise to very little long-term capital gain, and with respect to which the loss deferral rules and capital loss limitations otherwise would have applied to defer losses or limit their use by investors.

For funds that adopt a 'buy and hold' strategy, in which certain positions are held for periods intended to give rise to long-term capital gains on ultimate disposition, a Section 475(f) election is not generally advisable, as it accelerates taxable income and changes its character to ordinary. [FN13]

Example: Fund ABC's investors are individuals sensitive to the rate differential between ordinary income and capital gains. ABC owns security X, which it purchased for $100. At year-end, X's value has appreciated to $120. The investors in ABC will recognize ordinary taxable income of $20 if a Section 475(f) election is in place, resulting in an income tax liability of $7. [FN14] If, in the following year, X is sold for $110, the investors will have a $10 ordinary loss with a tax benefit of $3.50, resulting in total tax paid in respect of the $10 in appreciation of $3.50. Had the investment not been subject to a Section 475(f) election, however, the investors would have had $10 of long-term capital gain in year 2 and no income in year 1, resulting in total income tax liability of $1.50. [FN15] In addition to the benefit afforded by the lower rate of tax on long-term capital gains, ABC's investors also will obtain the timing benefit of deferring the payment of tax on the appreciation in X until its disposition in year 2.

If a fund with a Section 475(f) election in effect is the 'surviving partnership' in a merger, the Section 475 election will remain in effect for the merged entity. If the entity wishes to revoke the Section 475 election, it will have to apply to IRS for permission to do so. If a surviving fund intends to, in whole or in part, use a 'buy and hold' strategy, this could be problematic. [FN16]

To the extent, however, that assets are acquired by a surviving fund with a Section 475(f) election in place, mark-to-market taxation will apply only to changes in FMV of the assets after the date of contribution. The built-in gain or loss existing as of the date of contribution will be recognized under Section 704(c) principles as though the Section 475(f) election were not in place. [FN17]

754 election. A Section 754 election requires a partnership to adjust the basis of its assets on the occurrence of any one of the following:

1 A transfer of interests from one partner to another.
2 A distribution of cash to a partner on which the partner recognizes gain.
3 A distribution of property to a partner if the distributee partner's basis in the distributed property determined under Section 732 differs from the partnership's basis in the property immediately prior to the distribution. [FN18]

The purpose of a 754 election is to prevent the duplication of gains or losses on assets held in a partnership. [FN19] A Section 754 election is generally effective for the tax year in which it is made, and all subsequent tax years unless revoked by the partnership. In general, where a Section 475 election is in effect at all times during the life of a fund (and no appreciated assets are contributed to the fund), there would be no reason to make a Section 754 election as asset basis will, as a matter of course, track outside basis.

Different funds take different approaches to the issue of whether to make a Section 754 election. On one hand, a Section 754 election presents administrative and accounting difficulties, as it requires the fund to adjust asset basis each time that a distribution is made giving rise to taxable income or loss. It also requires a fund to make basis adjustments whenever an investor dies, thus requiring the fund to track such events.

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In funds using 'stuffing allocations,' whereby gains or losses are disproportionately allocated to a withdrawing partner in order to eliminate disparities between capital account value and basis, adjustments on investor withdrawals generally would be avoided via such allocation, rendering a Section 754 election largely unnecessary. For example, if an investor with a tax basis of $100 withdraws a capital account of $200, a stuffing allocation would provide for $100 of partnership taxable income to be disproportionately allocated to the withdrawing investor, thus resulting in no Section 734(b) adjustment in connection with the distribution.

In the context of hedge funds, however, many have questioned the substantial economic effect of stuffing allocations, and whether such allocations should be respected by the Service. [FN20] Moreover, a stuffing allocation avoids Section 734(b) basis adjustments only where there is sufficient gain (or loss) in the tax year of the withdrawal to cure book-tax disparities of withdrawing partners. Thus, where no stuffing allocation is made (either by reason of insufficient income or because the fund documents do not provide for one), a Section 754 election can be an effective planning tool. [FN21]

Example: Fund ABC has three investors, A, B, and C. Each made a $33 initial investment, and ABC purchased a portfolio of securities. After several years, the portfolio has increased in value to $198 (and ABC has not had any taxable income), at which point ABC has the balance sheet shown in Exhibit 1.

Exhibit 1. ABC's Balance Sheet at B's Departure

Assets:

Capital:

		Tax Basis		Book
	Tax Basis			Book
		---------		----
	---------		----	
Portfolio:		$99		$198
A	$33		$66	
B	33		66	
C	33		66	

B desires to withdraw his interest, causing ABC to sell one-third of its portfolio for $66. The $33 in taxable income recognized on this sale will be allocated $11 to each of A, B, and C. The $66 in cash generated from the sale then will be

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distributed to B in redemption. B will recognize $22 in gain on the distribution ($66 less $44 basis, which consists of B's $33 initial investment and $11 of income allocated to B on the sale of one-third of the portfolio).

If no Section 754 election is in effect, then immediately after B's withdrawal A and C will each have outside basis in their interests in ABC of $44 ($88 aggregate outside basis). ABC's basis in its portfolio, however, will be $66. Thus, if in the next year ABC sells its remaining portfolio for $132, ABC will have $66 of taxable income to allocate—$33 to each of A and C. Thereafter, the balance sheet of ABC will be as shown in Exhibit 2.

Exhibit 2. ABC's Balance Sheet After Portfolio Sale

Assets:

Capital:

	Tax Basis	Book
Cash:	$132	
	---------	----
A	$77	$66
C	77	66

A and C will have each recognized $11 more in taxable income than exists in the partnership, effectively duplicating the $22 of gain recognized by B on his withdrawal. While this duplication will be recaptured as a capital loss on a withdrawal by A and C, this loss is deferred and may be limited by the capital loss limitations of Section 1212 when it is ultimately recognized.

Had a Section 754 election been in effect for ABC, then on B's withdrawal, ABC's basis in the portfolio would have been increased by $22. When ABC sold the portfolio, allocable gain would thus have been $44, or $22 to each of A and C. Thus, A and C would have had a tax basis of $66, eliminating the book-tax disparity in their capital accounts, and preventing the duplication of gain.

Accordingly, funds that do not use Section 475(f) elections or stuffing allocations may wish to make Section 754 elections to protect non-withdrawing partners from the duplication of gain that can occur on a distribution in redemption. Combining funds should determine whether a Section 754 election is advisable given their circumstances and then either make, or revoke, the election as appropriate. IRS permission is required for the revocation of a Section 754 election, and such permission will not be granted where ‘the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.‘ [FN22]

Grandfathered Short Sales Against the Box

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Another potential issue, less frequently encountered but nevertheless significant, that could be implicated by the direction of the merger is the status of certain open short sale positions representing deferred capital gains. Generally, under Section 1259, a 'short sale against the box' (that is, a short sale of securities where the taxpayer holds an appreciated long position in the same securities) is treated as a constructive sale of the securities on the date of the short sale. [FN23]

An exception to this general rule protects 'grandfathered' short sales against the box. If the position was established before 6/9/97 and identified to the IRS as an open position prior to 9/4/97, then section 1001(d)(2) of TRA '97 provides relief from the constructive sale rules of Section 1259. In this situation, tax on the gain on the appreciation in the security that was present at the time of the short sale is deferred until the closing of the position.

Grandfathered status ceases to apply to open short sales against the box, however, 'as of the date such transaction is closed or the taxpayer ceases to hold such position.' If a merger of two funds is contemplated, and the smaller of the funds has grandfathered short sales against the box, then, as noted above, even if the merger is designed so that the smaller fund is the surviving entity under state law, the surviving entity for tax purposes will be the larger fund. This could be viewed as resulting in a change in the 'taxpayer' holding the position. Thus, a fund holding grandfathered short sales against the box may find it prudent to remain a separate tax partnership in order to retain the tax deferral benefits of the positions. [FN24]

FORM OF THE MERGER

In addition to the potential pitfalls regarding the direction of the fund merger, taxpayers must determine the form of the merger. Although state laws provide myriad means of effectuating partnership mergers, for federal income tax purposes partnership mergers can take only one of two forms: 'assets-up' or 'assets-over.' [FN25]

In an 'assets-up' partnership merger, the merging partnership liquidates and distributes its assets to its partners, who, immediately thereafter, re-contribute those assets to the surviving partnership. For a merger to qualify for assets-up treatment, the liquidation must actually occur, and title ownership to assets must be transferred to the existing partners in liquidation prior to its contribution to the surviving partnership. [FN26]

In an assets-over merger, the merging partnership is deemed to contribute all of its assets and liabilities to the surviving partnership in exchange for interests therein. The merging partnership then is deemed to liquidate and distribute interests in the surviving partnership in liquidation.

Where a form other than assets-up or assets-over is selected, the merger will be treated as an assets-over merger. [FN27]

Basis Considerations

In most cases, an assets-over merger will be preferable because it avoids the administrative difficulties of the actual distribution and re-titling of assets. Likewise, as is discussed below, there may be reasons to structure a merger as assets-over to avoid gain recognition under the partnership 'mixing-bowl' rules. Nevertheless, in certain circumstances there may be a tax advantage to the use of the assets-up form, such as where a disparity exists between inside and outside basis.

Example: The facts are the same as in the example above in which, because of the lack of a Section 754 election, after the withdrawal of partner B partners A and C each had outside basis in their partnership interests of $44 (for total outside basis of $88), while ABC itself had basis of $66 in its remaining portfolio. If at that moment partnership ABC were to

merge into another partnership, DEF, then, in an assets-over merger, ABC would contribute its assets to DEF in exchange for interests in DEF.

Under Section 723, DEF would have a basis of $66 in the acquired portfolio. ABC would then distribute interests in DEF to A and C. Under Section 732(b), A and C would take a basis in their interests in DEF equal to their outside basis in their ABC interests ($44). After the merger, A and C would be in the same situation that they had been in prior to the merger. They would have outside basis in their DEF interests of $44 and DEF would have inside basis in the portfolio of $66.

The result would be different if instead ABC and DEF used the assets-up form of merger. ABC would have distributed the portfolio to A and C in liquidation of their interests. Under Section 732(b), each of A and C would have basis in the portion of the portfolio distributed to him of $44. Immediately thereafter, A and C would have contributed the portfolio to DEF. That is, each would have contributed his respective half of the portfolio with basis of $44 and FMV of $66. Under Section 723, DEF thus would have aggregate basis in the portfolio of $88, eliminating the distortion that arose by virtue of B's withdrawal without a Section 754 election or stuffing allocation. Thus, in this situation (which is admittedly rare) the assets-up form would be preferable to the assets-over form. [FN28]

In this connection, there is a slight ambiguity as to whether, and to what extent, a Section 754 election in place at the surviving partnership (or a basis step-up to any partner of more than $250,000 [FN29]) will eliminate the benefits of using the assets-up form. In general, a Section 754 election will require that where a distribution of property results in the transferee realizing a basis increase, the basis of partnership property must be decreased by the amount of such basis increase. [FN30]

In a liquidation of a partnership, the adjustment generally will not occur because the partnership is no longer in existence after making the full liquidating distributions. *Query,* however, whether the Service could take the position that in the merger context, the separate liquidation and re-contribution should be stepped together, necessitating a downward basis adjustment to the property by the surviving partnership and thereby preserving the inside/outside basis disparity. In the author's opinion, the better position is that no such basis adjustment should be required. The language of Reg. 1.708-1(c)(3)(ii) provides that the assets-up form ‘will be respected‘ so long as a bona fide liquidation takes place. Giving respect to the form generally would require giving full effect to the separation between the liquidation and re-contribution, such that no basis reduction would be made by the surviving partnership. Nevertheless, to the author's knowledge the Service has not ruled on this particular fact pattern.

Once again, even where the assets-up form is selected and actual distribution is made, if the surviving partnership for state law purposes is not the ‘surviving partnership‘ under the partnership merger Regulations, the merger will be recast as an assets-over merger of the ‘terminating partnership‘ for federal income tax purposes into the ‘surviving partnership‘ for federal income tax purposes.

Partnership ‘Mixing Bowl‘ Issues

Generally, where appreciated property is contributed to a partnership, Section 704(c) requires that the unrealized gain existing as of the contribution date be allocated to the contributing partner. [FN31] Accordingly, Reg. 1.704-3(a)(3)(ii) requires that the disparity between an asset's FMV on the date of its contribution to the partnership (its book value) and the contributing partner's tax basis in the asset, be tracked. To the extent that the property is depreciable or amortizable, allocations of depreciation or amortization away from the contributing partner (using one of the methods prescribed in Reg. 1.704-3) may reduce the amount of this disparity. For purposes of this discussion, this unrealized gain (as the same may be reduced as a result of disproportionate allocations of depreciation or amortization) will be referred to as the ‘

Section 704(c) gain.‘

To prevent the contributing partner from shifting the burden of the tax on the Section 704(c) gain via distributions of appreciated property, [FN32] Section 704(c)(1)(B) provides that on a distribution of property with Section 704(c) gain to a noncontributing partner within seven years of the contribution of that property, the contributing partner must recognize the Section 704(c) gain in such property. Likewise, Section 737 provides that where a partner contributes appreciated property to a partnership, and other property is distributed to the contributing partner within seven years of the contribution, the contributing partner will be required to recognize the Section 704(c) gain in the contributed property. [FN33]

These Code provisions are commonly referred to as the partnership ‘mixing-bowl‘ rules. If one or more of the partners of the merging partnership in an assets-up merger has contributed property with built-in gain to the partnership within the seven-year period and, in the liquidation immediately preceding the re-contribution to the surviving partnership, either (1) that partner is the recipient of other property and/or (2) another partner is the recipient of the Section 704(c) property contributed by the contributing partner (one or both of which is almost sure to be the case absent highly unusual circumstances), the contributing partner may be required to recognize the Section 704(c) gain in the merger. In the case of a merging fund which is not itself the survivor of a previous merger, this danger exists only in the fairly unusual situation in which a partner in a hedge fund has made an in-kind contribution.

In the context of an assets-over merger, both Reg. 1.704-4(c)(4) and the Proposed Regulations issued in August 2007 specify that neither Section 704(c)(1)(C) nor 737 will apply to the contribution of property by the merging partnership to the surviving partnership and subsequent liquidation of the merging partnership. [FN34] After an assets-over merger, however, the Proposed Regulations provide a means by which Sections 704(c)(1)(C) and 737 will be applied to subsequent distributions with respect to:

1 The contributed property to the extent that it represents property with built-in gain prior to the merger (i.e., property contributed to the merged partnership with built-in-gain), or

2 Property with built-in gain at the time of the merger (i.e., property which at the time of the merger had appreciated in value from its original acquisition cost). [FN35]

With respect to the latter property, the seven-year period will begin on the date of the merger, and the built-in gain will be allocated among the capital accounts of the partners of the merged entity. Accordingly, after an assets-over merger, the merged entity must be careful in making in-kind distributions, as such distributions could trigger an allocation of tax gain to the historic partners of the merged partnership. Likewise, the surviving entity of an assets-over merger must be cognizant of the possibility of triggering gain on a subsequent assets-up merger.

INVESTMENT COMPANY

Generally, under Section 721(a), contributions of assets to a partnership in exchange for interests therein are not taxable events. Section 721(b), however, provides that the general rule of nonrecognition will not apply to a transfer to a partnership that would be an ‘investment company‘ under Section 351(e) if the partnership were incorporated.

Reg. 1.351-1(c)(1) provides that a transfer will be considered a transfer to an ‘investment company‘ if the transfer results in the diversification of the transferor's interests and more than 80% of the assets of the transferee are marketable securities. Under Reg. 1.351-1(c)(6)(i) (by reference to Section 368(a)(2)(F)(ii)), a transfer of a portfolio of stocks and securities will not be treated as resulting in diversification if both (1) no more than 25% of the value of the portfolio is invested in the stock and securities of one issuer and (2) no more than 50% of the value of the portfolio is invested in the stock and securities of five or fewer issuers. In most cases, hedge fund mergers will qualify under this exception, and no gain will be recognized as a result of a transfer to an ‘investment company.‘ [FN36]

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CONCLUSION

The partnership merger rules contain many provisions that could have special or unexpected application in the context of hedge fund mergers. Nevertheless, most of the tax issues raised in this article have fairly simple structural solutions that will not necessarily affect the economics of the arrangement.

In addition to the more common issues that may be encountered, however, myriad other issues could come up in any given transaction because of the wide range of activities and business lines that hedge funds engage in. Moreover, once the merger is structured to avoid the many potential problems outlined in this article, tax advisors must also be cognizant of tax risks inherent in the combination and integration of investment portfolios and strategies, which could include the creation of constructive sales under Section 1259, straddles under Section 1092, or wash sales under Section 1091.

Unlike corporations, the partnership Regulations provide mechanical tests for determining which entity is the ‘merged‘ entity and which is the ‘survivor.‘

Even if a fund ceases to qualify as a trader eligible to elect mark-to-market treatment, an election that already has been made should continue in effect.

There are very particular circumstances that might cause a fund to make a mark-to-market election under Section 475(f).

To the extent that assets are acquired by a surviving fund with a 475(f) election in place, mark-to-market taxation will apply only to changes in FMV after the contribution.

Generally, where a 475 election is in effect at all times during the fund's life (and no appreciated assets are contributed), there would be no reason to elect 754.

A Section 754 election could protect non-withdrawing partners from the duplication of gain that can occur on a distribution in redemption.

A fund holding grandfathered short sales against the box may find it prudent to remain a separate tax partnership in order to retain the tax deferral benefits.

In most cases, an assets-over merger will be preferable because it avoids the administrative difficulties of the actual distribution and re-titling of assets.

After an assets-over merger, the merged entity must be careful in making in-kind distributions, which could trigger an allocation of tax gain to the historic partners.

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Practice Notes

Funds that do not use Section 475(f) elections or stuffing allocations may wish to make Section 754 elections to protect non-withdrawing partners from the duplication of gain that can occur on a distribution in redemption. Combining funds should determine whether a Section 754 election is advisable given their circumstances and then either make, or revoke (with IRS consent), the election as appropriate.

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[FN1]. As used in this article, 'merger' and 'combination' will be used interchangeably (despite potential differences in meaning under state law) to mean a transaction in which two hedge funds pool their assets in a single surviving fund.

[FN2]. See generally 'Reluctant Hedge Fund Mergers,' 6/11/09 (available at www.HedgeCo.Net; last visited 6/18/09); 'More Forecasts of Mergers in Hedge Fund Industry,' 6/18/09 (available at dealbook.blogs.nytimes.com; last visited 8/28/09).

[FN3]. Foreign funds generally are organized as corporations so as to prevent foreign investors from recognizing income effectively connected with a U.S. trade or business and to prevent U.S. tax-exempt investors from recognizing unrelated business taxable income; see generally Sections 864, 512, and 514. Accordingly, separate issues will arise in merging offshore funds. Myriad issues also arise with respect to the combination of the investment managers themselves. This article is confined to a discussion of the combination of pooled investment funds, and does not address many issues that could arise with respect to general partner and/or investment manager combinations.

[FN4]. Many similar concerns arise in fund divisions; such issues are beyond the scope of this article.

[FN5]. The merger Regulations do not explicitly provide for the continuation of elections. The partnership division Regulations, however, state that '[a]ll resulting partnerships that are regarded as continuing are subject to preexisting elections....' See Reg. 1.708-1(d)(2)(ii) . In the absence of any regulatory language to the contrary, most practitioners believe that those elections of the surviving partnership in place prior to the merger will remain in place. See, e.g., Manning, 718-2nd T.M. (BNA), *Partnerships—Disposition of Partnership Interests or Partnership Business; Partnership Termination,* at III.B.1.c.

[FN6]. See generally Ginsburg and Levin, *Mergers, Acquisitions and Buyouts* (Wolters Kluwer, 2008). By way of example, a taxable forward merger often will be treated as an asset purchase by the surviving entity (see Rev. Rul. 69-6, 1969-1 CB 104), while a taxable reverse subsidiary merger generally will be treated as a stock purchase (see Rev. Rul. 73-427, 1973-2 CB 301).

[FN7]. Helvey and Stetson, 'The Doctrine of Election,' 62 Tax Lawyer 335 (Winter 2009).

[FN8]. See Higgins, 312 U.S. 212, 25 AFTR 1160 (1941). The determination of whether a fund is a 'trader' is particularly significant in the characterization of its deductions as trade or business deductions under Section 162 or as investment deductions under Section 212. For an in-depth discussion of when a fund will qualify as a trader, see Needham and Brause, 736 T.M. (BNA), *Hedge Funds,* at VIII.A.

[FN9]. Section 475(d)(3)(A)(i) generally provides that gains and losses will be ordinary in character. Reg. 1.475(d)-1 provides a limited exception from this rule for 'securities never held in connection with the taxpayer's activities as a dealer in securities.' Because the Regulation does not contemplate the statutory language permitting a trader in securities to elect mark-to-market accounting, there could be an argument that traders making Section 475(f) elections should treat all gains and losses as short-term capital. Nevertheless, in the absence of Regulations governing the treatment of traders making elections under Section 475(f), most practitioners take the position that the current Regulations should be applied by treating all references to 'dealers' as applying to 'traders' in the same manner.

[FN10]. Section 475(f)(3).

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[FN11]. See Needham and Brause, *supra* note 8, at IX.B.3.

[FN12]. See Reg. 1.1291-1(c)(4) . Generally, under the 'excess distribution' regime, if a fund holds stock in a PFIC, then on disposition of that stock (or certain distributions on that stock), the fund will be required to allocate gain over its holding period for the stock. To the extent that gain is allocated to a period, the tax on that gain will be added to the tax paid for that period, and will be subject to an interest charge at the underpayment rate. This can be avoided by making a 'qualified electing fund' (QEF) election, whereby gain of the PFIC is recognized on a flow-through basis by the fund each year. To make a QEF election, however, the PFIC must be willing and able to provide certain information to the fund annually. Moreover, if a QEF election is not made in the first year that the fund owns an interest in the PFIC, the excess distribution regime will apply to a subsequent disposition of the PFIC stock unless a 'purging election' is made whereby all unrealized gain in the PFIC stock is recognized as an excess distribution for tax purposes; see Section 1291(d)(2)(A). Section 1296 allows for a mark-to-market election with respect to PFICs without the taxpayer being required (or even, necessarily, permitted) to make a Section 475(f) election. Nevertheless, mark-to-market tax accounting may be elected under the PFIC regime only for PFIC stock that is publicly traded; see Section 1296(e)(1). While the use of Section 475 elections in PFIC planning is a broader subject that cannot be described in great detail in this article, where a QEF election is impossible, annual inclusion of ordinary income is often preferable to the excess distribution regime of Section 1291, as treatment of gain or dividends as 'excess distributions' requires that tax be assessed and allocated to years in the taxpayer's holding period without regard to items of deductions or loss available to the taxpayer in the years to which such tax is allocated.

[FN13]. Of course, this may be of limited importance where the investors in a fund are C corporations, which are largely indifferent to character differences.

[FN14]. Assuming a 35% tax rate on ordinary income.

[FN15]. Assuming a 15% tax rate on long-term capital gains.

[FN16]. Section 475 contemplates that securities not held as part of the trade or business of trading in securities need not be marked to market; see Section 475(f)(1)(B). Where a fund is a trader for federal income tax purposes, however, the fact that active trading does not occur with respect to a particular security held as part of the overall trading strategy of the fund should not exempt that security from mark-to-market treatment unless the fund can show that the security is not held as part of its trading business (as may be the case where a fund holds an illiquid security as part of a so-called 'side pocket'). If securities are held outside of the trading 'trade or business' of a fund, then deductions attributable to those securities will be treated as investment deductions under Section 212, and limited under Section 67 (2% AGI floor for miscellaneous itemized deductions), Section 68 (overall limitation on itemized deductions), and Section 56(b) (disallowance of miscellaneous itemized deductions in calculation of the alternative minimum tax).

[FN17]. Reg. 1.475(a)-3(b)(1) provides that 'Section 475(a) applies only to changes in value of the security occurring after the acquisition.' Reg. 1.475(a)-3(b)(2) states that '[a]ny built-in gain or loss with respect to the security (based on the difference between the fair market value of the security on the date the dealer acquired it and its basis to the dealer on that date) is taken into account at the time, and has the character, provided by the sections of the Internal Revenue Code that would apply to the built-in gain or loss if section 475(a) did not apply to the security.' Thus, on appreciation in value, only the difference between FMV at year-end and FMV on the date of contribution is recognized as ordinary income. Less clear, however, is the treatment of depreciation in value where total FMV at year-end still exceeds basis. Should the depreciation in value be recognized as an ordinary loss despite representing unrealized depreciation in value? Though the Regulation is somewhat ambiguous on this point, the author believes that the intent of the Regulation is to

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preserve the character of any book-tax disparity existing on the date of contribution. This reading would prohibit the recognition of loss on a reduction in built-in-gain. For the application of Section 704(c), see the discussion of the partnership 'mixing bowl' rules in the text, below.

[FN18]. Sections 743(b) and 734(b) .

[FN19]. Many have suggested that Section 754 elections be made mandatory to avoid potential economic distortions that can arise where a Section 754 election is not in effect. See, e.g., Osofsky, 'Solving Section 734(b)' 60 Tax Lawyer 473 (Winter 2007).

[FN20]. See Needham and Brause, *supra* note 8, at V.D.

[FN21]. When a partner dies, a Section 754 election generally will aid that partner's estate by virtue of a Section 743(b) adjustment to the inside basis of partnership property. Prior to 2010 and after the sunset of the relevant provisions of EGTRRA, Section 1014 generally would provide the estate of the deceased partner with outside basis equal to the FMV of its fund interest. Where a Section 754 election is in place, the estate would likewise obtain an inside basis step-up, but unlike a Section 734(b) adjustment, that basis increase would be available only for the use of the estate (and its beneficiaries). Even where no Section 754 election is in effect, however, a transferee partner in such circumstances may make an election under Section 732(d) to treat its share of inside basis as though a Section 754 election had been in effect. Unless Congress acts to the contrary, the special basis rules of Section 1014 are repealed during 2010.

[FN22]. Reg. 1.754-1(c)(1) .

[FN23]. A short sale against the box generally locks in appreciation by providing the taxpayer with cash in an amount equal to the appreciated value of the securities. Any subsequent reduction in value will result in gain on the short position and offsetting loss on the long position, while any subsequent appreciation in value will result in gain on the long position and offsetting loss on the short position. In the absence of Section 1259, the short sale would thus result in immediate realization of the appreciation in value, with the tax consequences arising only on a later closing of the short position. See Section 1233.

[FN24]. Because the merging partnership is being combined with another existing partnership (rather than being split into two new partnerships), keeping it alive as a separate entity should not be treated as a partnership 'division' under Reg. 1.708-1(d) .

[FN25]. Reg. 1.708-1(c)(3) .

[FN26]. Reg. 1.708-1(c)(3)(ii) .

[FN27]. Reg. 1.708-1(c)(3)(i) .

[FN28]. In the event that the assets-up form is selected, each partner of the terminating partnership should be distributed a pro-rata share of each assets of the partnership. If instead specific assets are distributed in kind to the various partners, the partners are at risk for the recognition of gain under Section 751(b), which treats a distributee partner as having received a pro-rata share of 'inventory items which have appreciated substantially in value' and 'unrealized receivables' of the partnership and as having exchanged such items for the other property received in the distribution in a taxable transaction. See Reg. 1.751-1(b)(3) . Likewise, a contribution of individual assets rather than a pro-rata portion of the entire portfolio held by the terminating partnership could result in gain recognition under Section 721(b). See note 36, *infra,* and the discussion of Section 721(b) in the text.

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[FN29]. See Section 734(d) and note 30, *infra.*

[FN30]. Section 734(b)(2)(b). Pursuant to Section 734(d), if the downward basis adjustment would exceed $250,000, such an adjustment generally would be required even in the absence of a Section 754 election.

[FN31]. The Regulations also extend this general rule to situations in which property is purchased in partnership solution, but is subsequently revalued on the books of the partnership to reflect unrealized appreciation. In many (if not most) funds that do not have Section 475(f) elections in place, unrealized gains are generally reflected in the capital accounts of the partners at the end of each fiscal year and on withdrawals and admissions of partners. See Reg. 1.704-1(b)(2)(iv)(*f*) . The special allocations of gains (or depreciation or amortization) described in the text, above, are, in the case of revalued property, commonly referred to as ‘reverse Section 704(c) allocations.‘ Reverse Section 704(c) allocations may be done on an asset-by-asset basis. Hedge funds qualifying as ‘securities partnerships‘ may elect to instead use an ‘aggregate approach‘ in making reverse Section 704(c) allocations, whereby taxable gains and losses from any source may be disproportionately allocated to remedy book-tax disparities. The discussion in the text focuses only on Section 704(c) gain arising by reason of a contribution of property, as current Prop. Reg. 1.704-4(c)(7) provides that ‘Section 704(c)(1)(B) ... do[es] not apply to reverse section 704(c) gain or loss.‘ A similar rule applies for purposes of Section 737 under Prop. Reg. 1.737-2(e). In August 2009, however, the IRS issued a notice soliciting comments on a variety of issues concerning the application of Sections 704(c)(1)(B) and 737, including the proper accounting for reverse Section 704(c) gains and losses. See Notice 2009-70, 2009-34 IRB 255; see generally Pillow and Dance, ‘Notice 2009-70: A Focus on Complex Section 704(c) Netting vs. Layering Issues,‘ 111 JTAX 336 (December 2009).

[FN32]. See S. Fin. Comm., *Explanation of Provisions Approved by the Committee on Oct. 3, 1989* (Comm. Print 1989), page 196, cited in Notice 2009-70, *supra* note 31.

[FN33]. See Reg. 1.737-1 .

[FN34]. See REG-143397-05, 8/22/07; Prop. Regs. 1.704-4(c)(4)(i) and 1.737-2(b)(1)(i). See generally Lipton, ‘Proposed Regulations on Built-In Gain and Partnership Mergers: The Service Refuses to Budge,‘ 107 JTAX 324 (December 2007).

[FN35]. Prop. Regs. 1.704-4(c)(4)(ii) and 1.737-2(b)(1)(ii).

[FN36]. Where the assets-up form of merger is used, this assumes that each partner has received a pro-rata share of each of the assets held in the partnership portfolio. See note 28, *supra.*

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