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Client Alert

A report for clients and friends of the firm

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IRS Issues Guidance on Electing Investment Partnerships; Provides "No Trade or Business" Safe Harbor

On April 1, 2005, the IRS issued Notice 2005-32 (the "Notice") providing guidance for partnerships seeking to elect out of the mandatory basis adjustment rules added by the American Jobs Creation Act of 2004. These mandatory basis adjustment rules—the so-called "754 adjustments"—generally require partnerships to adjust the tax basis of their assets (partner-by-partner and asset-by-asset) upon certain transfers of partnership interests, and certain distributions of partnership property, after October 22, 2004. With respect to transfers of interests in partnerships, the mandatory basis adjustments are required only if (i) immediately after the transfer, the partnership has a built-in loss in excess of $250,000, and (ii) the partnership is not an "electing investment partnership" ("EIP"). The Notice sets forth the requirements for making an EIP election; establishes a safe harbor to satisfy the "no trade or business" requirement for qualification as an EIP; and outlines new reporting requirements for EIPs and their transferor partners.

Making an EIP Election

To make an EIP election, a partnership must attach a written statement to its tax return for the first taxable year in which the election is intended to be effective. The statement must contain (i) the name, address and taxpayer identification number of the partnership, (ii) a representation that the partnership is eligible to make the election, and (iii) a declaration that the partnership elects to be treated as an EIP. Once made, the election is also effective for all succeeding taxable years, unless the partnership no longer qualifies as an EIP or the election otherwise is revoked. Revocation, however, generally requires IRS consent. If a partnership has already filed its 2004 tax return without such a statement (and its interests were transferred—by sale, exchange or upon the death of a partner—after October 22, 2004 at a time immediately after which the partnership had a built-in loss in excess of $250,000), it must file an amended return, generally by October 15, 2005, to make a valid EIP election for the 2004 taxable year.

"No Trade or Business" Safe Harbor

Among other requirements, a partnership is eligible to make an EIP election only if it has never been "engaged in a trade or business." For other tax purposes, if a partnership (the "upper-tier partnership") owns an interest in another partnership (the "lower-tier partnership"), the upper-tier partnership will be treated as engaged in the activities conducted by the lower-tier partnership. The Notice, however, provides that an upper-tier partnership will not—solely for purposes of the mandatory basis adjustment rules—be treated as engaged in a trade or business conducted by a lower-tier partnership, so long as the upper-tier partnership's adjusted tax basis in the lower-tier partnership is at all times less than 25% of the aggregate capital commitments of the partners of the upper-tier partnership. Accordingly, a fund of funds (or a private equity fund with an interest in a portfolio company organized as a partnership or LLC) that meets this safe harbor generally will be eligible to make an EIP election—assuming that the other EIP requirements are satisfied.

Reporting Requirements

One consequence of being an EIP is that its transferee partners are subject to a loss disallowance rule. As a result, the Notice imposes the following reporting requirements on EIPs and their transferor partners:

- **Separate Statement of Gains and Losses.**
  Unlike non-electing investment partnerships, an EIP is required to state separately to all of its partners, on Schedules K and K-1 of its tax return, all of its gross gains and losses. If an EIP files a tax return in which gains and losses are not separately stated (including returns already filed for 2004), the EIP must file an amended return. If an EIP is not required to file a return (for example, certain non-US partnerships), a transferee may be required to provide the IRS with information regarding its distributive share of gross gains and losses of the EIP.

- **Annual Election Notice.**
  An EIP must attach an annual statement to each partner's Schedule K-1 notifying the partners of its election to be treated as an EIP and the consequences of the election to transferors and transferees of the EIP interests. If an EIP issues Schedules K-1 without the annual statement (including schedules already issued for 2004), it must provide amended schedules.

- **Transferor Notice.**
  If an EIP interest is transferred by sale or exchange (or upon the death of a partner), the transferor, or its representative, must provide a written notice to both the transferee and the EIP, generally within 30 days after the transferor receives its Schedule K-1. Among other requirements, the notice must include detailed information about losses (if any) recognized by the transferor and certain of its predecessors with respect to the transferred interest.

The private equity industry lobbied heavily for the EIP exception to the mandatory basis adjustment rules. While the Notice provides some much needed guidance in this area, both in terms of mechanical compliance with EIP status as well as the "no trade or business" safe harbor, the IRS has indicated that it is still considering these issues and that subsequent guidance may be less favorable to taxpayers. The IRS has also indicated that if a partnership does not qualify as an EIP under future guidance, the partnership's EIP election will terminate for transfers occurring on or after the effective date of such future guidance.

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