SEWARD & KISSEL LLP

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Memorandum to Our Investment Management Clients and Friends

Mandatory Tax Basis Adjustments for Partnerships

Recently enacted tax legislation (the "Act") requires partnerships to reduce the tax basis of their securities in certain circumstances. Prior to the enactment of the Act, these basis adjustments were elective under Section 754 of the Internal Revenue Code, rather than mandatory. In our experience, the vast majority of investment partnerships did not make elective Section 754 basis adjustments due to the significant administrative burdens and costs involved in implementing these basis adjustments on a continuing basis whenever the partnerships made distributions to its partners or whenever partners died or transferred interests in the partnership to another person.

In the case of a distribution of securities to a retiring partner, if the partner's tax basis for his partnership interest immediately before the distribution (reduced by any cash distributed in the transaction) exceeds the partnership's tax basis for the distributed securities by more than $250,000, the Act requires the partnership to reduce the tax basis of its remaining securities by the entire amount of the excess. In other words, a basis reduction is required when the amount of the partnership's unrealized gain with respect to the distributed securities exceeds the partner's unrealized gain with respect to his partnership interest by more than $250,000. A partnership may wish to utilize the "gain stuffing" or "fill up" provision of its partnership agreement as an alternative to distributing securities in kind to a retiring partner. Pursuant to such a provision, the retiring partner would be specially allocated tax gains of the partnership so as to reduce the amount of gain realized by the partner upon the redemption of his partnership interest.

Further, if a retiring partner realizes a loss of more than $250,000 upon the redemption of his partnership interest, the Act requires the partnership to reduce the tax basis of its securities by the amount of the partner's loss. In order to avoid the need to make such basis adjustments, a partnership may wish to consider amending its partnership agreement to provide for a "loss stuffing" or "fill down" provision. (Such an amendment generally will require the consent of the limited partners.) Pursuant to such a provision, the retiring partner would be specially allocated tax losses of the partnership so as to reduce the amount of loss realized by the partner upon the redemption of his partnership interest.

Based on the foregoing, we recommend that existing partnerships consider amending their governing documents to allow for both gain and loss stuffing. If you have any questions concerning these matters, please contact Peter Pront or Dan Murphy in our Tax Group at 212-574-1200.

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