OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSISTANT REGIONAL COUNSEL (LARGE CASE),

ATTN:

FROM: WILLIAM C. SABIN, JR.
Senior Technician Reviewer, Passthroughs & Special Industries Branch, Field Service Division
CC:DOM:FS:P&SI

SUBJECT:

This Field Service Advice responds to your memorandum dated . Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Partnership X =
Y =
$a =
$b =
$c =
A% =
Date 1 =
Date 2 =
Date 3 =
Year 1 =

ISSUE:

Should the “open transaction” principle embodied in Treas. Reg. § 1.1233-1(a)(1) be applied to determine when an obligation incurred by a partnership taxpayer in connection with a short sale transaction of Treasury Bills is able to be included in the basis of partnership assets?

CONCLUSION:

No. The “open transaction” principle embodied in Reg. § 1.1233-1(a)(1) applies only to the timing of gain or loss recognition for federal income tax purposes from the sale of the Treasury bills in the short sale transaction. The principle does not apply to the determination of when the obligation is able to be included in the basis of partnership assets.

FACTS:

After various telephone conferences, we have narrowed the issue for consideration in this memorandum to the above-noted issue statement. We have summarized the facts as noted below and limit our analysis to the question presented.

On Date 1 of Year 1 and Date 2 of Year 1, partnership X engaged in short sales of Two-Year Treasury Notes (Notes). Partnership X acquired these Notes with an aggregate face amount of $a from an unrelated securities lender and agreed to return identical or similar securities to this lender. The agreement to return identical or similar Notes to the lender created an obligation upon partnership X. Partnership X sold the Notes to an unrelated party for $b and deposited the proceeds of the sale in a margin account as required by the terms of the agreement with the securities lender.

On Date 3 of Year 1, Y acquired A% of partnership X. The parties have stipulated that this acquisition resulted in a technical termination of partnership X under Internal Revenue Code § 708(b)(1)(B) for purposes of applying the partnership rules under Subchapter K. The parties have stipulated that the effect of this constructive termination was as follows: (1) Under I.R.C. § 732(b), partnership X was deemed to distribute its properties to partners in proportion to each partner’s preexisting outside basis; and (2) Under I.R.C. §§ 723 and 722, the partners were deemed to contribute the partnership property to the successor partnership, giving the partnership property a carryover basis equal to the basis in the hands of the contributing partners.

Following this transaction, successor partnership X closed the short sale transaction by acquiring identical or similar Notes from an unrelated party for $c and satisfying its obligation to return those identical or similar Notes to the lender.

The parties disagree over whether the obligation that partnership X incurred in connection with the short sale transaction should have increased the basis of the partnership assets prior to the constructive termination of partnership X. The taxpayer is expected to argue that the obligation had a zero basis prior to closing the transaction and, therefore, the value of the obligation could not be included in the basis of the partnership assets prior to the constructive termination. Respondent takes the position that under I.R.C. §§ 752(a) and 722, the value of the obligation is included in the basis of the partnership assets prior to the termination, with a concomitant increase in the bases of the partners' partnership interests. You have asked us to consider whether the "open transaction" principle embodied in Reg. § 1.1233-1(a)(1) supports the taxpayer's position in this case.

LAW AND ANALYSIS

Open transaction reporting relates to the timing of gain or loss recognition. It applies in the "rare and extraordinary" instance when there is a sale or other disposition of property in which the fair market value of the property, and thus the taxpayer's amount realized, is so uncertain that the taxpayer is permitted to delay reporting gain or loss until the taxpayer has enjoyed a recovery of basis. Burnet v. Logan, 283 U.S. 404 (1931). In order to avoid computation of gain based on "mere estimates, assumptions and speculation," the transaction is deemed to be open rather than closed for gain reporting purposes.[1]

Reg. § 1.1233-1(a)(1) adopts open transaction reporting in short sales by stating,"[f]or income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale." Thus, Reg. § 1.1233-1(a)(1), similar to the open transaction principle, relates to the timing of gain recognition in a short sale. Specifically, the regulation provides that, in a short sale, gain or loss is recognized when the replacement securities are delivered to the lender to close the short sale.

The general principle set forth in Reg. § 1.1233-1(a)(1) has been followed in Hendricks v. Commissioner, 51 T.C. 235 (1968), aff'd 423 F.2d 485 (4th Cir. 1970). In Hendricks, the Tax Court sustained the position of the Service that short sale losses claimed by the taxpayer should not be taken into account until the taxable year when the actual delivery of the shares to cover the short sale took place. Hendricks follows the timing rule for gain or loss treatment expressed in Reg. § 1.1233-1(a)(1), but sets no standard for governing basis of the obligation in a short sale.

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[1]Boris J. Bittker & Martin J. McMahon, Jr., Federal Income Taxation of Individuals ¶ 26.13 (1988) (quoting Burnet v. Logan, 283 U.S. 404, 412.

Neither I.R.C. §1233 nor Reg. § 1.1233-1(a)(1) prescribe or suggest when the obligation that arises in a short sale transaction is included in basis of the partnership assets. In addition, there is nothing in the legislative history of I.R.C. §1233 or in the history of Reg. § 1.1233-1(a)(1) to suggest such a rule exists. See generally, Staff of Joint Comm. on Internal Revenue Taxation, 83d Cong., 2d Sess., Summary of the New Provisions of the Internal Revenue Code of 1954 104 (Comm. Print 1955); S. Rep. No. 1622, 83d Cong., 2d Sess. 113, 436 (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 83, A277 (1954), and; T.D. 6207, 1956-2 C.B. 529.

Our position is that the only provisions which govern the determination of when the value of an obligation is included in the basis of the partnership assets are the partnership rules under Subchapter K, specifically, I.R.C. §§ 752, 732 and 722.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

No more case development is needed on the I.R.C. §1233 issue. Section 1233 and the regulations promulgated thereunder do not pose any hazards to the Service's position in this case.