

PROP. REGS. ON DISTRIBUTIVE SHARE OF PARTNERSHIP ITEMS

The IRS has issued proposed regulations under Section 706 that address the determination of partners' distributive shares of partnership items of income, gain, loss, deduction, and credit when a partner's interests varies during a partnership's tax year. The proposed regulations also modify the existing regulations that determine the required tax year of a partnership. The amendments are intended to conform the regulations to certain provisions of section 1246 of TRA '97 and section 72 of DRA '84.

Varying interests rule. The proposed regulations amend Reg. 1.706-1(c) to reflect the change made to Section 706(c)(2)(A) by TRA '97 requiring that the tax year of a partnership close with respect to a partner who dies. The proposed regulations also provide for the application of the varying interests rule in all cases where a partner's interest changes during the tax year, whether by reason of a disposition of the partner's entire partnership interest or a disposition of less than his or her entire interest.

Methods and conventions. Prop. Reg. 1.706-4(a) provides that if a partner's interest changes during the partnership's tax year, the partnership will determine the partner's distributive share using the interim closing method. The partnership may, however, by agreement of the partners, use the proration method. For each partnership tax year in which a partner's interest varies, the proposed regulations provide that the partnership must use the same method to take into account all changes occurring within that year.

Prop. Reg. 1.706-4(c) provides that a partnership must take into account any variation in the partners' interest in the partnership during the tax year by determining the distributive share of partnership items for each segment of the tax year using an interim closing of the books method and by allocating those items among the partners in accordance with their respective interests during that segment.

Prop. Reg. 1.706-4(d) states that by agreement among the partners, a partnership may use a proration method, rather than the interim closing method, when taking into account any variation in a partner's interest. Under the proration

method, the partnership allocates the distributive share of partnership items (except for extraordinary items) under Section 702(a) among the partners in accordance with their pro rata shares of the items for the entire tax year. The partnership must take into account a partner's interest in partnership items during each segment of the tax year.

Prop. Reg. 1.706-4 requires that for each partner whose interest changes in the tax year, the partnership must maintain segments to account for the changes. A segment is a specific portion of a partnership's tax year. The first segment of a tax year for a partner who has a change in interest begins on the partnership's first day of its tax year and ends as of the close of business immediately preceding the date of the change. The next segment begins on the day prescribed by the applicable convention and ends on the earlier of the close of the day immediately preceding the date of the subsequent change or the end of the partnership's tax year. Each segment is treated as a separate period.

For purposes of the interim closing and proration methods, the proposed regulations provide a special accounting rule that must be used to account for certain items. For example, any limitation applicable to the partnership year as a whole must be apportioned among the segments using any reasonable method, provided that the method may not exceed any limitation applicable to the partnership as a whole.

Prop. Reg. 1.706-4(d)(3) requires a partnership using the proration method to allocate extraordinary items among the partners in proportion to their interest at the beginning of the day on which they are taken into account. An extraordinary item is:

1. Any item from the disposition or abandonment of a capital asset (other than in the ordinary course of business) as defined in Section 1221 (determined without the application of any other rules of law).

2. Any item from the disposition or abandonment of property used in a trade or business (other than in the ordinary course of business) as defined in Section 1231(b) (determined without the application of any holding period requirement).
3. Any item from the disposition or abandonment of an asset described in Section 1221(1), (3), (4), or (5), if substantially all the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions).
4. Any item from assets disposed of in an applicable asset acquisition under Section 1060(c).
5. Any Section 481(a) adjustment.
6. Any item from the discharge or retirement of debt (e.g., if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse debt, any discharge of debt income recognized under Section 108(e)(8) must be allocated among those who were partners in the partnership immediately before the discharge).
7. Any item from the settlement of a tort or similar third-party liability or payment of a judgment.
8. Any credit, to the extent it arises from activities or items that are not ratably allocated (e.g., the rehabilitation credit under Section 47, which is based on placement in service).
9. Any item that, in the opinion of the IRS, would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included.

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Prop. Reg. 1.706-4(e) provides that a partnership using the interim closing method may use either a calendar-day convention or a semi-monthly convention, whereas a partnership using the proration method may use only the calendar-day convention. The calendar-day convention requires that the partnership's tax year closes as of the close of the day on which the change in a partner's interest occurs. The semi-monthly convention, on the other hand, requires that any variation in a partner's interest occurring during the first through 15th day of a calendar month is deemed to occur at the beginning of the first day of the month, and any variation occurring during the 16th through the end of the month is deemed to occur at the beginning of the 16th day of the month.

A partnership must use the same method and convention for all variations in the partners' interest during the partnership's tax year. A partnership could not, for example, use the proration method and interim closing method in the same tax year.

Change in allocations among contemporaneous partners. Prop. Reg. 1.706-4(b)(1) provides that the varying interests rule will not preclude changes in the allocations among contemporaneous partners resulting from amendments to the partnership agreement made no later than the due date of the partnership return for the tax year (excluding extensions). This exception applies only to allocations that are valid under Section 704(b) and will not apply to any changes in interests of the partners attributable to contributions of money or other property to the partnership or to changes in the interests of partners as a result of distributions of capital from the partnership to a partner.

Safe harbors for service and publicly traded partnerships. Under Prop. Reg. 1.706-4(b)(2), service partnerships may allocate items relating to the provision of services using any reasonable method to account for changes even though the method is not described in Prop. Reg. 1.706-4(a) and a partnership does not use

the methods or conventions described in Prop. Regs. 1.706-4(c), (d), and (e) (but the allocations must be valid under Section 704(b)).

Prop. Reg. 1.706-4(b)(3) provides that a publicly traded partnership may treat all transfers of its publicly traded units during a calendar month as occurring on the first day of the following month under a consistent method adopted by the partnership or may use the semi-monthly convention. Block transfers of publicly traded partnership units will not qualify for the safe harbor.

Deemed dispositions. The proposed regulations amend Reg. 1.706-1(c) to provide that a deemed disposition of a partner's entire interest pursuant to Regs. 1.1502-76(b)(2)(vi), 1.1362-3(c)(1), and 1.1377-1(b)(3)(iv) will be treated as a disposition of the partner's entire interest for purposes of Section 706.

Partnership tax year. The proposed regulations amend the minority interest rule in Reg. 1.706-1(b)(6)(iii) to provide that regarded partners (i.e., partners that are not disregarded foreign partners) have a minority interest in a partnership only if each regarded partner has less than a 10% interest in capital and profits, and if the regarded partners, collectively, have less than a 20% interest in partnership capital and profits. The modification means that the interest of foreign partners will be taken into account in determining the tax year of the partnership only if the regarded partners have interests below the stated thresholds, unlike the current rule which requires only an interest below the threshold in *either* capital or profits.

Effective date. The proposed regulations provide a reasonable transition period for taxpayers. The proposed amendments to Regs. 1.706-1(c), 1.706-1(b)(6)(iii), 1.706-4, and 1.706-5 are proposed to apply to partnership tax years that begin after the date the final regulations are published, but not before tax years beginning after 12/31/09. ■