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New Rules Clarify Allocations to Partners Who Vary Interests

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Under the tax law, partnerships are generally flexible entities. In theory, a partnership may amend its partnership agreement to change its partnership allocations for a taxable year until the due date for that year's tax return. This once led to abuses where a partnership would admit a new partner on the final days of the taxable year and allocate to that partner income or losses that were generated before the admittance, in effect allowing people to buy and sell tax benefits. The Tax Court in response held that a partnership cannot allocate partnership items retroactively to new partners, who are generally entitled only to items arising while they are a partner.[1] In the converse case of departing partners, Treasury issued regulations limiting the partnership items that could be allocated to partners who disposes of their entire partnership interests during the partnership's taxable year.[2]

The case law and regulations dealing with allocations to new partners or departing partners were premised on the fundamental concept that partnership items should not be allocated to anyone who is not a partner. From the perspective of the new partner, the partnership's taxable year begins on the date the partner joins, while the partnership year closes with respect to a partner who terminates its entire interest;[3] partnership items that predate the joining or postdate the complete disposition are not allocable to that partner. However, the concept that partnership items cannot be allocated to non-partners does not prohibit the allocation of any items to partners who merely vary their partnership interests. The issue becomes what proportion of each partnership item should be allocated to that partner, not whether that particular item could be allocated to him at all. In determining how the partnership items should be allocated to an existing and continuing partner, the current regulations simply provide that his distributive share shall be determined by "taking into account his varying interests in the partnership during the taxable year."[4]

Treasury has recently issued Proposed Treasury Regulation § 1.706-4, which provides detailed rules for how partnerships items should be allocated to partners who vary their partnership interests during the partnership's taxable year. The rules apply to any variations in partnership interests that occur not only when partners make complete dispositions of their partnership interests, as under the current regulations, but also when partners make partial dispositions of their partnership interests. The proposed regulations provide for a default method, the "interim closing method," while the partners may by agreement choose to use the "proration method."

Under the interim closing method, sometimes known as the "closing-of-the-books method," the partnership divides its taxable year into segments and allocates its items among the partners in accordance with their respective partnership interests during the segments, as if each segment were a separate taxable year. (Any limitation applicable to the partnership year as a whole, such as the Section 179 expensing limits, must be apportioned among the segments using any reasonable method.) For example, assume that partners A and B are in a calendar-year partnership (AB), engaged in the trade or business of developing condominiums. On June 30, A acquires half of B's partnership interest so that A owns 75 percent of the AB partnership for the rest of the year. AB partnership sells a condo in February at a loss of $200, and sells another condo in November at a profit of $240. In allocating the distributive shares to the partners under the interim closing method, the partnership divides the year into two segments and "closes its books" after the first segment. Losses of $100 each are allocated to A and B for the first segment, which begins on Jan. 1 and ends as of the close of June 30. In the next segment, from July 1 to Dec. 31, A is allocated $180 of income and B is allocated $60 of income. For the entire year, B has $40 of losses and A has $80 of income. This example shows that

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under the interim closing method, a partner can have a loss even though the partnership has a net gain for the year.

The interim closing method is precise but cumbersome, since it requires the partnership to allocate all tax items to specific periods within the year. The less precise "proration method" generally does not require the partnership to determine the exact date when partnership items were paid or accrued. The partnership's tax items, which are netted at the end of the taxable year, are prorated throughout the year. The year is still divided into segments, and a partner's partnership interest during each segment determines the partner's share of the prorated items. For the AB partnership, the proration method would allocate the year's $40 of net income to the two segments based on the number of days in each segment. For the entire year, B would be allocated about $15 of income, which is the sum of $10 (B's 50 percent share of the approximately half of $40 allocated to the first segment) and $5 (B's 25 percent share of the approximately half of $40 allocated to the second segment). A would be allocated approximately $25 of the partnership's net income.

The proration method's allocations do not apply to certain tax items defined as "extraordinary items," which include any item from the disposition or abandonment of a capital asset or property used in a trade or business, if the disposition or abandonment does not occur in the ordinary course of business. The disposition or abandonment of non-capital assets, such as inventory, results in extraordinary items only if substantially all the same general class of assets from the same trade or business are disposed of or abandoned in one transaction or several related transactions. If instead of condos the AB partnership had sold rental properties (in transactions not in the ordinary course of business), the income and loss from the sales would be extraordinary items and would be required to be allocated in accordance with A's and B's partnership interests at the beginning of the day on which the sales occurred. B would, therefore, be allocated half the $200 loss from the first sale and a quarter of the $240 profit on the second sale; for extraordinary items, there would be no difference between the interim closing method and the proration method. Extraordinary items also include cancellation of indebtedness items, certain tax credits, and items from the settlement of third-party liabilities.

The special treatment of extraordinary items prevents a partnership using the proration method from completely ignoring the fact that certain tax items are realized discretely on a single day. In a general way, this treatment complements Section 706(d)(2), which prevents partnerships from taking advantage of the fact that certain other tax items are recognized under the cash method of accounting on individual days even though they accrued ratably as an economic matter. For purposes of partner allocations, Section 706(d)(2) requires all cash method partnerships to accrue daily certain "cash basis" items, such as interest, taxes, and payments for services or property use. The partnership must assign a pro rata share of any allocable cash basis item to the partners for each day. For instance, if the cash-method AB partnership makes an annual interest payment on December 31, the interest that accrued during the first half of the year must be allocated half to B, even though B owns only 25 percent of the partnership when the payment is made.

Partnerships using the interim closing method may choose either the calendar day convention, where a segment ends at the close of any day in which a variation occurs in a partner's interest in the partnership, or the semi-monthly convention, where any variation occurring during the first through 15th day of a calendar month is deemed to have occurred on the last day of the previous month, while any variation in the rest of the month is deemed to have occurred on the 15th of the month.[5] A partnership on the proration method must use the calendar day convention, presumably because the method's less cumbersome nature reduces the justification for simplifying conventions. A partnership must use the same method and convention for all variations in the partnership interests during a single taxable year. Treasury is requesting comments on whether to allow other conventions or methods.

The proposed regulations contain several safe harbors regarding the allocation rules and conventions. Service partnerships,[6] such as law firms, may allocate items relating to the provisions of services among its partners using any reasonable method. Publicly traded partnerships may treat all transfers of its publicly traded units, except block trades, during a calendar month as occurring on the first day of the following month under a consistent method. Furthermore, existing publicly traded partnerships using the proration method can keep using any conventions that they have already adopted instead of the calendar day convention.

Treasury proposed the new regulations on April 14, 2009, to be effective for partnership taxable years that begin after the date the final regulations are published in the Federal Register, but not before taxable years beginning after Dec. 31, 2009. The statutory authorization for these regulations was first enacted in 1984.[7] While the regulatory guidance provided 25 years later is helpful to a certain extent, the rules and conventions, especially the extraordinary items exception to the proration method, still fall short of providing practical and simple solutions for the increasing number of partnerships without static ownership.

[1] *Lipke v. Comr.*, 81 T.C. 689 (1983).
[2] Treas. Reg. § 1.706-1(c).
[3] Section 706(c)(2)(A) of the Internal Revenue Code.
[4] Treas. Reg. § 1.706-1(c)(4).
[5] The two segments of the AB partnership under the semi-monthly convention would run first from Jan. 1 to June 15, and then from June 16 to Dec. 31.
[6] Service partnerships are defined as partnerships in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.
[7] Section 706(d)(1).