Reg. 1.706-1(c)(2) (Aug. 3, 2015)

Final Regs. On Tax Year Closure for Deceased Partner (1997 Act Change)

Reg. 1.706-1(c)(2) first sentence:

“A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in the partnership, with respect to a partner whose entire interest in the partnership is liquidated, and with respect to a partner who dies.”
Final Reg. Example

• H is a partner of a partnership having a taxable year ending December 31.

• Both H and his wife W are on a calendar year and file joint returns.

• H dies on March 31, 2015.

The partnership tax year closes with respect to H on 3/31/2015
H’s Final Form 1040:

Partnership Income
1/1/2015 – 3/31/2015

Reg. 1.706-1(c)(2) final sentence:

“The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition.”
The partnership interest, is distributed to W as legatee on November 30, 2015.

- W’s 2015 Form 1040 distributive share of partnership income is for: 4/1/2015 - 12/31/2015
- Nothing is allocated to the estate
T.D. 9728; Regs. 1.706-1, -4, -5
(Aug. 3, 2015)

Final Regulations On Varying Interest Rules

Partnership tax years that begin on or after
Aug. 3, 2015
Note the importance of electing the proration method for simplicity!

A Variation
• Sale, exchange or liquidation of entire interest or death of partner closing the tax year with respect to the partner, or

• Sale or exchange of less than entire interest

• Reduction of a partner’s interest resulting from the entry of a new partner.

• None of the “variations” closes the partnership year for the entire partnership.
Allocations Not Governed by Reg. 1.706-4:

- Certain debt discharges.

- Share of allocable cash basis items.

- Share of item of upper tier partnership attributable to lower tier partnership.
The interim closing method is the default, and the proration method must be elected.

Segments are specific periods of the partnership's taxable year created by interim closings of the partnership's books.
Proration periods are specific portions of a segment created by a variation for which the partnership chooses to apply the proration method.

A partnership generally uses the calendar day convention for each variation.
With the *interim closing method*, the partnership may instead use the *semi-monthly or monthly convention* by agreement of the partners.

**Semi-monthly Convention**

Each variation is deemed to occur either:

a) If occurring on the 1st through the 15th day of a calendar month, at the end of the last day of the prior month.
b) If occurring on the 16th through the last day of a calendar month, at the end of the 15th calendar day of that month.

Monthly Convention

Each variation is deemed to occur either:

a) If occurring on the 1st through the 15th day of a calendar month, at the end of the last day of the prior month.
b) If occurring on the 16th through the last day of a calendar month, at the end of the last day of that calendar month.

Step-by-Step Approach (Ten Steps)
Reg. 1.706-4(a)(4) Example

At the beginning of 2016, PRS, a calendar year partnership, has three equal partners, A, B, and C.

- **On April 16, 2016**, A sells 50% of its interest in PRS to new partner D.

- **On August 6, 2016**, B sells 50% of its interest in PRS to new partner E.

Variation:

If

**April 16, 2016**, A sold his entire 1/3 interest to D on

**On August 6, 2016**, B sold his entire 1/3 interest to E.

A deemed termination of the partnership on Aug. 6, 2016.
Reg. 1.706-4(a)(4) Example
At the beginning of 2016, PRS, a calendar year partnership, has three equal partners, A, B, and C.

- **On April 16, 2016**, A sells 50% of its interest in PRS to new partner D.

- **On August 6, 2016**, B sells 50% of its interest in PRS to new partner E.

---

**Entire 2016 Year (In Thousands)**

- 75 Ordinary Income
- 33 Ordinary Deductions
- 12 Cap. Gain (ord. course)
- <9> Cap. Loss (ord. course)
First, PRS determines that none of the exceptions in paragraph (b) apply because capital is a material-income producing factor and no variation is the result of a change in allocations among contemporaneous partners.

Second, PRS determines that none of its items are extraordinary items subject to allocation under paragraph (e).
Third, the partners of PRS agree to apply the proration method to the April 16, 2016, variation, and PRS accepts the interim closing method for the August 6, 2016, variation.

Agreement Reg. 1.706-4(f)

“...the dated written agreement must be maintained with the partnership's books and records by the due date, including extension, of the partnership's tax return.”
Php. Agreement
PRS agrees to use the proration method and calendar day convention for the variation on April 16, 2016
Date: January 30, 2017

Php. Agreement
For variations using the interim closing method, the partnership agrees to use the semi-monthly convention.
Date: January 30, 2017
Fourth, PRS determines the deemed date of the variations for which interim closing is applied (Aug. 6):

Semi-Monthly so the Aug. 6, 2016 closing is deemed to occur July 31

Fifth, the partners of PRS do not agree to perform regular semi-monthly or monthly closings so July 31 is the only interim closing.
**Sixth: Two Segments:**

1. 1/1/2016 to 7/31/2016
   - Books Closed

2. 8/1/2016 to 12/31/2016
   - Books Closed

**Seventh: amounts in each segment (in thousands):**

1. 1/1/2016 to 7/31/2016
   - 60 Ord. Inc.
   - 24 Ord. Ded.
   - 12 Cap. Gain
   - <6> Cap. Loss

2. 8/1/2016 to 12/31/2016
   - 15 Ord. Inc.
   - 9 Ord. Ded.
   - <3> Cap. Loss
**Eighth:** Two Proration Periods (April 16 Sale):

<table>
<thead>
<tr>
<th></th>
<th>1/1/2016 to 4/16</th>
<th>4/17 to 7/31</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days</td>
<td>106 Days</td>
<td>106 Days</td>
</tr>
<tr>
<td>Ord. Inc.</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Ord. Ded.</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>Cap. Gain</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>Cap. Loss</td>
<td>&lt;6&gt;</td>
<td></td>
</tr>
</tbody>
</table>

**Ninth:** Prorate

<table>
<thead>
<tr>
<th></th>
<th>1/1/2016 to 4/16</th>
<th>4/17 to 7/31</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days</td>
<td>106 Days of 212</td>
<td>106 Days of 212</td>
</tr>
<tr>
<td>Ord. Inc.</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Ord. Ded.</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Cap. Gain</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Cap. Loss</td>
<td>&lt;3&gt;</td>
<td>&lt;3&gt;</td>
</tr>
</tbody>
</table>
Tenth: Each Ptr’s Share

First Proration Period:

1/1 to 4/16
106 Days of 212

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>12</td>
<td>6</td>
<td>&lt;3&gt;</td>
</tr>
</tbody>
</table>

A, B, and C prorate 1/3 each:

10 Ord. Inc.
4 Ord. Ded.
2 Cap. Gain
<1> Cap Loss

Second Proration Period:

4/17 to 7/31
106 Days of 212

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>12</td>
<td>6</td>
<td>&lt;3&gt;</td>
</tr>
</tbody>
</table>

Same for B, and C: 1/3 each.
A and D are 1/6 each:

5 Ord. Inc.
2 Ord. Ded.
1 Cap. Gain
<.5> Cap Loss
Review of Facts
On August 6, 2016, B sells 50% of its interest in PRS to new partner E.

Interim Closing is used with the semi-monthly convention.

Second Segment:  
8/1/2016 to 12/31/2016
15 Ord. Inc.  
9 Ord. Ded.  
<3> Cap. Loss
A, B, D, and E each 1/6:  
2.5 Ord. Inc.  
1.5 Ord. Ded.  
<.5> Cap Loss
C 1/3: 5 O.I., 3 ord. ded. and <1> cap loss.
C’s 1/3 interest did not change all year.

Impact of segments and proration periods on C?

None

Entire 2016 Year

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary Income</td>
<td>75</td>
</tr>
<tr>
<td>Ordinary Deductions</td>
<td>33</td>
</tr>
<tr>
<td>Cap. Gain (ordinary course)</td>
<td>12</td>
</tr>
<tr>
<td>Cap. Loss</td>
<td>&lt;9&gt;</td>
</tr>
</tbody>
</table>

No Difference For C:

C’s 1/3 Share:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ord. Inc.</td>
<td>(10 + 10 + 5)</td>
</tr>
<tr>
<td>Ord. Ded.</td>
<td>(4 + 4 + 3)</td>
</tr>
<tr>
<td>Cap. Gain</td>
<td>(2 + 2)</td>
</tr>
<tr>
<td>Cap Loss</td>
<td>(&lt;1&gt; + &lt;1&gt; + &lt;1&gt;)</td>
</tr>
</tbody>
</table>
How would E be impacted if PRS agreed to proration for all variations?
(no interim closings)

Php. Agreement

PRS agrees to use the proration method and calendar day convention for all variations.

Date: X/XX/20XX
Recall with Interim Closing

- **On August 6, 2016**, 1/3 partner B sells 50% of its interest in PRS to new partner E.

- **With Interim Closing July 31, 2016:**

  E’s 1/6:
  - 2.5 Ord. Inc.
  - 1.5 Ord. Ded.
  - <.5> Cap Loss

Two Segments with Interim Closing

<table>
<thead>
<tr>
<th>Segment</th>
<th>Books Closed</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1/1/2016 to 7/31/2016</strong></td>
<td></td>
</tr>
<tr>
<td>60 Ord. Inc.</td>
<td></td>
</tr>
<tr>
<td>24 Ord. Ded.</td>
<td></td>
</tr>
<tr>
<td>12 Cap. Gain</td>
<td></td>
</tr>
<tr>
<td>&lt;6&gt; Cap. Loss</td>
<td></td>
</tr>
<tr>
<td><strong>8/1/2016 to 12/31/2016</strong></td>
<td></td>
</tr>
<tr>
<td>15 Ord. Inc.</td>
<td></td>
</tr>
<tr>
<td>9 Ord. Ded.</td>
<td></td>
</tr>
<tr>
<td>0 Cap. Gain</td>
<td></td>
</tr>
<tr>
<td>&lt;3&gt; Cap. Loss</td>
<td></td>
</tr>
</tbody>
</table>
With No Interim Closing

One Segment:

1/1/2016 to 12/31/2016

75 Ordinary Income
33 Ordinary Deductions
12 Cap. Gain (ord. course)
<9> Cap. Loss (ord. course)
### Three Proration Periods:

<table>
<thead>
<tr>
<th>Periods</th>
<th>1/1/2016 to 4/16/2016</th>
<th>4/7/2016 to 8/6/2016</th>
<th>8/7/2016 to 12/31/2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days</td>
<td>106 Days of 365</td>
<td>112 Days of 365</td>
<td>147 Days of 365</td>
</tr>
<tr>
<td>O.I</td>
<td>21.8</td>
<td>23</td>
<td>30.2</td>
</tr>
<tr>
<td>O.D</td>
<td>9.6</td>
<td>10.1</td>
<td>13.3</td>
</tr>
<tr>
<td>C.G.</td>
<td>3.5</td>
<td>3.7</td>
<td>4.8</td>
</tr>
<tr>
<td>C.L.</td>
<td>&lt;2.6&gt;</td>
<td>&lt;2.8&gt;</td>
<td>&lt;3.6&gt;</td>
</tr>
</tbody>
</table>

### For E (Aug. 6 Buyer):

<table>
<thead>
<tr>
<th>Periods</th>
<th>8/7/2016 to 12/31/2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days</td>
<td>147 Days of 365</td>
</tr>
<tr>
<td>O.I</td>
<td>21.8</td>
</tr>
<tr>
<td>O.D</td>
<td>9.6</td>
</tr>
<tr>
<td>C.G.</td>
<td>3.5</td>
</tr>
<tr>
<td>C.L.</td>
<td>&lt;2.6&gt;</td>
</tr>
</tbody>
</table>

\[
\begin{align*}
5 \text{ O.I.} & = (30.2 \times \frac{1}{6}) \\
2.2 \text{ O.D.} & = (13.3 \times \frac{1}{6}) \\
.8 \text{ C.G.} & = (4.8 \times \frac{1}{6}) \\
<.6 \text{ C.L.} & = (<3.6> \times \frac{1}{6})
\end{align*}
\]
With Interim Closing

E’s 1/6:
  2.5 Ord. Inc.
  1.5 Ord. Ded.
  <.5> Cap Loss

With Proration (rounded):
  5 Ord. Inc.
  2 Ord. Ded.
  .8 Cap. Gain
  <.6> Cap. Loss

What if C is allocated all <$9,000> of capital losses and that allocation has substantial economic effect?

OK, Contemporaneous Partner Exception
What if E, on Aug. 6, 2016, contributed additional capital to the partnership in exchange for E’s 1/6 interest

Can E be allocated <$6,000> of capital losses that arose before E became a partner?
No

(1) not a contemporaneous partner for entire tax year and

(2) The variation is attributable to a capital contribution.

*Lipke v. Comm’r*

81 T.C. 689 (1983)

Granted, if the proration method is used, E is allocated a portion of the <$6,000> of capital losses that arose before E became a partner
Extraordinary Items

Include:

- Disposition or abandonment of capital asset or 1231 asset not in ordinary course of T or B.

- Disposition or abandonment of substantially all inventory in one transaction.
• Any item from a change in accounting method initiated by the filing of “the appropriate form after a variation occurs.” (3115?)

• COD income with exceptions.

• Settlement or judgment from tort or “similar liability”.

• Any additional item if the partners agree.

• Any item which the IRS determines would, “if ratably allocated, result in a substantial distortion of income...”
• Any item identified as an additional class in the Internal Revenue Bulletin.

Example (not in text)
Return to the original PRS example.

What if PRS receives a taxable tort settlement for $100,000 on Aug. 3, 2016 and B wants E to recognize as much as possible?

Review of Facts
On August 6, 2016, B sells 50% of its interest in PRS to new partner E.

Interim Closing is used with the semi-monthly convention.
Segments With Interim Closing and Semi-Monthly Convention?

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/2016 to 7/31/2016</td>
<td>60</td>
<td>24</td>
<td>12</td>
<td>&lt;6&gt;</td>
</tr>
<tr>
<td>8/1/2016 to 12/31/2016</td>
<td>15</td>
<td>100</td>
<td>9</td>
<td>&lt;3&gt;</td>
</tr>
</tbody>
</table>

The tort settlement is an extraordinary item and it must be attributed to Aug. 3, at the time of day it arose.
Neither proration nor interim closing can be applied to an extraordinary item.

B is allocated 1/3 of the $100,000 extraordinary item.

None to E who was not yet a partner on Aug. 3.
Reg. Example 5

A and B each own a 15 percent interest in PRS, a partnership that is not a publicly traded partnership and for which capital is a material income-producing factor.

On April 25, 2016:

9:00 AM:   A sells to D

3:00 PM:  PRS incurs extraordinary item

5:00 PM:  B sells to E
PRS must allocate the extraordinary item in accordance with the partners' interests at 3:00 p.m. on April 25, 2016.

None allocated to A who sold at 9:00 AM

None allocated to E who purchased at 5:00 PM
Extraordinary Item Small Item Exception

- Less than 5%

and

- Less than $10 million

(individual item and aggregate tests)

REG-109370-10 (Aug. 3, 2016)

Proposed Regulations on Allocable Cash Basis and Tiered Partnership Items
Prop. Regs.
Effective When Finalized

Two Proposed Extraordinary Items
Proposed Additional Extraordinary Item for Publicly Traded Partnerships (PTPs) relating to withholding on FDAP payments to foreign persons (can rely on prop. regs.)

Proposed additional extraordinary item for partnership equity for services
“The Treasury Department and the IRS have concluded that, in the case of a transfer of a partnership interest in connection with the performance of services, no portion of the partnership's deduction should be allocated to the person who performs the services.”

To ensure this “the proposed regulations add to the list of extraordinary items ... any deduction for the transfer of an interest in the partnership in connection with the performance of services, and
clarify that such extraordinary item is treated as occurring immediately before the transfer or vesting of the partnership interest that results in compensation income for the person who performs the services.

**Preamble Warning with reference to 2005 Prop. Regs.:**

The Treasury Department and the IRS continue to consider the interaction of section 83 with partnership taxation principles.
No inferences should be drawn from these proposed regulations as to the resolution of the issues addressed in the proposed Partnership Equity for Services regulations or any other related issues.

Allocable Cash Basis Items
“Section 706(d)(2)(A) provides that if during any taxable year of the partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item shall be determined.
(i) by assigning the appropriate portion of such item to each day in the period to which it is attributable, and

(ii) by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day.”

Allocable Cash Basis Items

• interest

• taxes, and

• payments for services or for the use of property (i.e., rent or royalties).
• Prop regs. add “any allowable deduction that had been previously deferred under section 267(a)(2)” (accrual method Php. deduct in year included in income – when paid)

Proposed De Minimis Rule

• Less than 5%

and

• Less than $10 million

(individual item and aggregate tests)
Prop. Reg. Example 2

In 2016, E, F, and G are equal one-third partners in PRS, a calendar year partnership that uses the cash receipts and disbursements method of accounting.

- On December 31, 2016, E sells her entire interest in PRS to H.

- In November 2017, PRS makes a $6,000 payment for the use of property that is attributable to the period from January 1, 2016 to December 31, 2017.
• Assume the de minimis exception does not apply.

• Half of the $6,000 expense is attributable to 2016 and must be assigned to January 1, 2017.

• Of this $3,000 assigned to January 1, 2017, one third is allocable to each E, F, and G.

• However, because E is not a partner in 2017, PRS must capitalize E's $1,000 share of the expense.
• Because E sold her interest to H, PRS must treat the capitalized $1,000 similar to a section 743(b) adjustment for H allocated among PRS's property under the principles of §1.755-1(b)

Prop. Reg. Example 3

• Assume the same facts as Example 2, except that on December 31, 2016, PRS distributed property to E in complete redemption of E's interest, and H never becomes a partner in PRS.
• PRS must capitalize E's $1,000 share of the expense.

• However, because E was redeemed, PRS must instead treat the capitalized $1,000 similar to a section 734(b) common basis adjustment allocated among PRS's property under the principles of §1.755-1(c).
The proposed regulations provide that the daily allocation method used for cash basis items applies to ALL ITEMS of the lower-tier partnership if there is a change in any partner's interest in the upper-tier partnership.

Example 1
UTP uses the proration method and calendar day convention to account for variations during its taxable year.
All of LTP’s $100,000 of ordinary deductions are attributable to Jan. 1, 2016 Thru July 1, 2016

LTP has no extraordinary items

UTP’s share of LTP’s deductions is $15,000 (15%)
A sells her entire 1/3 interest in UTP To D on Aug. 1, 2016

“UTP must assign the $15,000 equally among all days from January 1, 2016 to July 1, 2016, and allocate the assigned daily portions among its partners in accordance with their interests in UTP on those days.”
No deductions are allocated to D

$5,000 each to A, B, and C

Proposed De Minimis Relief From section 706(d)(3)
The proposed regulations provide an exception from section 706(d)(3) if:

1) the upper-tier partnership directly owns an interest in less than 10 percent of the profits and capital of the lower-tier partnership ("a de minimis upper-tier partnership")

2) all de minimis upper-tier partnerships in aggregate own an interest in less than 30 percent of the profits and capital of the lower-tier partnership, and
3) no partnership is created with a purpose of avoiding the application of the tiered partnership rules of section 706(d)(3).

Example 2

Same as Ex 1

Except UTP is a 9% partner in LTP ($9,000 of Deductions)
De Minimis Rule applies and UTP uses proration method for the entire year under reg. 1.706-4
A was a partner in UTP for 213 days, and D was a partner in UTP for 152 days, so UTP allocates between A (213/365) and D (152/365) accordingly.

$9,000 deduction allocated:

$3,000 to B
$3,000 to C
$1,750.68 to A
$1,249.32 to D
Example 3

Same as Ex 2, but UTP uses interim closing method

Although UTP qualifies for the de minimis relief...

No Relief with Interim Closing Method
“UTP's distributive share of LTP items is considered to have been realized or sustained by UTP at the same time and in the same manner as such items were realized or sustained by LTP”

$9,000 deduction allocated:

$3,000 to A
$3,000 to B
$3,000 to C
$0 to D
Strangely, the proposed regulations do not impose on lower-tier partnerships an obligation to disclose to upper-tier partnerships the timing of the lower-tier partnership's items.