New York State Bar Association
Tax Section

Report on Proposed Regulations on Varying Partnership Interests Under Section 706

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Report No. 1201

New York State Bar Association Tax Section

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Introduction

This report[1] comments on the proposed regulations under Section 706 of the Code[2] that were issued on April 14, 2009 relating to the determination of a partner's distributive share of partnership items of income, gain, loss, deduction, and credit when the partner's interest in the partnership varies during the taxable year of the partnership (the "Proposed Regulations"). Under the Proposed Regulations, if for example a partner sells some or all of its interest in a partnership, the partner's distributive share of partnership items for the year of sale is determined pursuant to one of two methods for allocating partnership income throughout the year, and may also depend on a convention for determining when the sale is deemed to take place. In general, while we welcome the guidance provided by the Proposed Regulations on the application of these methods and conventions, we believe that partnerships should have considerably more flexibility in selecting and combining methods and conventions than would be permitted by the Proposed Regulations, subject to certain limitations in order to prevent abuse.

This report is divided into four parts. The first part contains a general summary of the background, current law and regulations relating to the treatment of varying partnership interests. Part II contains a summary of the Proposed Regulations. Part III contains a list of our recommendations. Part IV contains a discussion of our recommendations regarding the Proposed Regulations.

I. Summary of Current Law

Under Section 701, partnerships are not subject to federal income tax; instead, each partner is liable for federal income tax on its distributive share of partnership income in its individual capacity.[3] Each partner's distributive share of a partnership's items of income, gain, loss, deduction, and credit is generally determined in accordance with the allocation provisions of the partnership agreement, provided that such allocations have "substantial economic effect" within the meaning of Section 704(b).[4] A partner's distributive share of partnership tax items for a

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1 The principal drafter of this report was Joel Scharfstein. Significant contributions were made by Stephen Foley, Monte Jackel, David Mayo and Eric Sloan. Helpful comments were received from Andrew Berg, Stephen Mills, Andrew Needham, Erika Nijenhuis, David Schnabel, and Michael Schler.

2 Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" or "Prop. Reg. §" are to the Treasury regulations promulgated or proposed thereunder.

3 Section 701.

4 Sections 704(a) and (b).

partnership's taxable year is generally includable in the partner's taxable year that ends with, or includes, the last day of the partnership's taxable year.[5]

Under Section 706(c)(2), the taxable year of a partnership will close with respect to a partner at the time the partner's interest in the partnership terminates.[6] If a partnership's taxable year closes with respect to a partner, that partner will include its distributive share of the income of the partnership in such partner's taxable year that ends with, or includes, the date the partnership's taxable year closes with respect to such partner.[7] The taxable year of a partnership will not close with respect to a partner whose interest in the partnership is reduced, but not terminated, during that year before the end of the partnership's taxable year.[8]

Section 706(d)(1) provides that if during any taxable year of a partnership there is a change in a partner's interest in the partnership, each partner's distributive share of partnership items of income, gain, loss, deduction, and credit will be determined by the use of any method prescribed in Treasury regulations that takes into account the varying interests of the partners in the partnership during such taxable year. This provision is known as the "varying interest rule."

A version of the varying interest rule has been in the Code since 1954 and was originally included in Sections 706(c)(2)(A) and (B).

In 1956, Treas. Reg. § 1.706-1(c)(2) was issued to address sales, exchanges or liquidations of a partner's entire interest in a partnership.[9] Under that regulation, the distributive share of partnership items allocable to a partner whose interest in the partnership has terminated may be determined using an interim closing of the partnership's books (the "interim closing method") or, by agreement among the partners, may be determined using a proration method.[10] The proration may be based on the portion of the partnership's taxable year that elapsed prior to the terminating event "or may be determined under any other method that is reasonable."[11] No other regulations have been issued with respect to the varying interest rule of Section 706. The current Treasury regulations do not address how a partner's distributive share should be determined when a partner's interest in the partnership changes but does not terminate.

Section 706(d) was added to the Code by Section 72 of the Deficit Reduction Act of 1984 (the "1984 Act") to consolidate the varying interest rules previously found in Sections 706(c)(2)(A) and (B)[12] into Section 706(d)(1),[13] and to add Sections 706(d)(2) and (d)(3).

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5 Section 706(a).

6 Section 706(b)(2). In addition, the taxable year of a partnership will close with respect to all partners upon termination of the partnership, or upon reaching the normal year end.

7 Treas. Reg. § 1.706-1(c)(2)(ii).

8 Section 706(c)(2)(B).

9 T.D. 6175, 1956-1 C.B. 211.

10 This regulation was issued with respect to the varying interest rule as the rule existed prior to the 1976 Act.

11 Treas. Reg. § 1.706-1(c)(2)(ii).

12 Section 706(c)(2)(A) of the 1954 Code covered sales, exchanges and liquidations of a partner's entire interest in the partnership, and Section 706(c)(2)(B) of the 1954 Code covered sales or exchanges of less than the entire interest of a partner, as well as other reductions in a partner's interest. Section 213 of the 1976 Tax Reform Act, P.L. 94-455, amended Section 706(c)(2) of the 1954 Code to clarify that it covered not only sales or exchanges

The 1984 Conference Report stated that the conferees contemplated that regulations under Section 706 would be issued providing for conventions, including a monthly convention under which partners entering after the 15th day of the month would be treated as entering on the first day of the following month and partners entering during the first 15 days of the month would be treated as entering on the first day of that month.[14] The 1984 Joint Committee Report stated that Congress intended that regulations providing for conventions would only apply prospectively and that until such regulations were proposed, it was expected that the Treasury Department would permit taxpayers to use any reasonable convention.[15] After passage of the 1984 Act, Treasury issued News Release 84-129,[16] which announced that partnerships using the interim closing method would be permitted to use a semi-monthly convention under which partners entering during the first 15 days of the month would be treated as entering on the first day of the month and partners entering after the 15th day of the month would be treated as entering on the 16th day of the month.[17] News Release 84-129 also provided that, until regulations were issued, partnerships using the proration method must use a daily convention. News Release 84-129 did not specifically prohibit the use of conventions other than the semi-monthly convention when the interim closing method was used.

Section 706(d)(2) provides that, in the case of a partnership that uses the cash receipts and disbursements method of accounting, if the interests of the partners vary during the taxable year, "allocable cash basis items" are assigned to each day in the taxable year to which they are economically "attributable" and then allocated among the partners in proportion to their interests in the partnership at the close of each such day. These rules effectively require that the allocable cash basis items be allocated among the partners as if the partnership were using the accrual method of accounting. The items to which the provision applies are deductions for interest, taxes, payments for services or for the use of property, and any other item of a kind that Treasury regulations identify as allowing for significant misstatements of the partners' income if the rule were not applicable. Special rules are provided for instances in which the allocable cash basis item is attributable to periods before or after the end of the taxable year in which the item is recognized for tax purposes.

Section 706(d)(3) addresses the situation in which one partnership (an "upper tier partnership") is a partner in another partnership (a "lower tier partnership") and there is a change in any

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of interests among partners, but also other changes in interest, including reductions in interest resulting from the entry of new partners.

13 Prior to the 1984 Act, the varying interest rule for complete terminations of interests contained in Section 706(c)(2)(A) provided that the determination of varying interests would be made under regulations prescribed by the Secretary. Other variations were covered by Section 706(c)(2)(B), which provided that determinations would be made "by taking into account [the partner's] varying interest in the partnership during the taxable year." Section 706(d)(1), as described in the text above, expressly provides that in all applicable cases, varying interests are to be accounted for under methods prescribed in regulations prescribed by the Secretary.

14 Conference Report to P. L. 98-369 (July 18, 1984) at 858 [the "1984 Conference Report"]; *see also* JOINT COMM. ON TAX'N, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, H.R. 4170, 98th CONG. (Dec. 31, 1984) at 222 [the "1984 Joint Committee Report"].

15 *Id.*

16 IRS News Release IR-84-129 (Dec. 13, 1984).

17 Except to the extent Section 706(c)(2)(A) applies.

partner's interest in the upper tier partnership during the taxable year. In that case, Section 706(d)(2) provides that, "except to the extent provided in regulations," each partner's distributive share of any items of the upper tier partnership that are attributable to its interest in the lower tier partnership will be determined by assigning the appropriate portion of each such item (determined by applying principles similar to those of Section 706(d)(2)) to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership, and then allocating the portion assigned to each such day among the partners in proportion to their interests in the upper tier partnership at the close of that day.[18] To date, no regulations or other guidance have been issued under Sections 706(d)(2) or (d)(3).

Sections 706(d)(2) and 706(d)(3) were added to address attempts by taxpayers to circumvent the varying interest rule (1) by having a partnership that uses the cash receipts and disbursements method of accounting defer actual payment of accrued deductions until near the end of the partnership's taxable year, and (2) by taking the position that the tax items of a lower tier partnership should be allocated to the day in the upper tier partnership's taxable year on which the lower tier partnership's taxable year closes.[19] Sections 706(d)(2) and 706(d)(3) respond to these concerns by providing special rules for cash basis partnerships that have "allocable cash basis items" and for tiered partnership structures, respectively.

Under Section 761(c), partners may amend a partnership agreement with respect to a taxable year on or prior to the due date of the partnership's federal income tax return for that taxable year (not including extensions). These amendments to a partnership agreement are given retroactive effect, subject to the varying interest rule of Section 706 and provided that they comply with Section 704(b). The 1984 Joint Committee Report states that it is anticipated that the Treasury regulations to be issued under Section 706(d) will not override the rule of Section 761(c) with respect to interest shifts among partners who are members of the partnership for the entire taxable year, provided that such shifts are not, in substance, attributable to the influx of new capital from such partners.[20]

II. Description of Proposed Regulations

The Proposed Regulations provide a uniform set of rules for determining a partner's distributive share of partnership items that apply if a partner's interest in the partnership varies during the taxable year as a result of (i) a sale, exchange or liquidation of the partner's entire interest in the partnership, (ii) a sale or exchange of part of the partner's interest in the partnership, (iii) the death of the partner, or (iv) any other reduction in the partner's interest in the partnership (collectively, a "Covered Variation").[21]

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18 The Joint Committee Report states that "[e]ffectively, under this rule the existence of the tiered partnership arrangement is ignored for allocation purposes and the items of the lower-tier partnership 'flow through' to the partners in the upper tier partnership in accordance with their effective interest in the lower-tier partnership as of the close of each day." 1984 Joint Committee Report, *supra* note 14, at 221.

19 1984 Conference Report; *see also* 1984 Joint Committee Report, *supra* note 14, at 221.

20 1984 Joint Committee Report, *supra* note 14, at 219 (citing *Lipke v. Comm'r*, 81 T.C. 689 (1983)).

21 Prop. Reg. § 1.706-4(a)(1). *See also* Prop. Regs. §§ 1.706-1(c)(2) and (3). The rules relating to Covered Variations do not, however, cover (i) dispositions by gift or (ii) any transfer of an interest that occurs at death as a result of inheritance or any testamentary disposition. Prop. Reg. § 1.706-1(c)(2). Note that the Proposed

The Proposed Regulations provide two "methods" that can be used to account for Covered Variations. Under the default method of the Proposed Regulations, the partnership will determine the partner's distributive share of partnership items using the interim closing method.[22] Alternatively, by agreement of the partners, the partnership is permitted to use the proration method.[23] For example, in the case where the Covered Variation is a sale of a partnership interest these methods provide rules for apportioning the transferred interest's distributive share of partnership items for the taxable year of the Covered Variation between the transferor and transferee partners.

Under the Proposed Regulations, where there are Covered Variations, the application of both the interim closing method and the proration method require the division of a partnership taxable year into segments.[24] The first segment begins on the first day of the partnership's taxable year and ends at the close of any day on which a Covered Variation occurs (or is deemed to occur).[25] Any additional segment begins at the beginning of the day following the end of the preceding segment and ends on the earlier of the close of the day on which an additional Covered Variation occurs (or is deemed to occur) or the close of the partnership's taxable year.

Under the interim closing method, the partnership determines the partnership items attributable to each segment within the taxable year and allocates those items among the partners in accordance with their respective partnership interests during that segment.[26] Under the proration method, the partnership allocates a pro rata portion of each partnership item (other than "extraordinary items" discussed below) to each segment during the taxable year of the partnership and then allocates those items among the partners in accordance with their respective partnership interests during that segment.[27] If the proration method is used, and there are extraordinary items during the taxable year, the partnership allocates such items among the partners in accordance with their interests at the beginning of the calendar day on which they are taken into account by the partnership. The Preamble to the Proposed Regulations (the "Preamble")[28] states that Proposed Regulations regarding the proration method are intended to incorporate the principles of former Treas. Reg. § 1.706-2(c)(2)(ii).

Regulations provide no guidance as to when a partnership distribution constitutes a "reduction in interest" within the meaning of this provision. *Cf.* Treas. Reg. § 1.706-1(c)(4).

22 Prop. Reg. § 1.706-4(a).

23 *Id.*

24 Prop. Reg. § 1.706-4(a)(1). Technically, under the Proposed Regulations, it appears that a Covered Variation causes the creation of a segment only as to partners whose interests are changed as a result of the Covered Variation.

25 Prop. Reg. § 1.706-4(a)(2)(i). *See* discussion, *infra* Section IV.B., regarding "Available Conventions" under which Covered Variations may be deemed to occur on dates specified by a convention, which may differ from the dates on which the actual disposition or other variation occurs.

26 *Id.*

27 Prop. Reg. § 1.706-4(a)(2)(i).

28 REG-144689-04, 2009-18 I.R.B. 906, *Doc 2009-8357*, *2009 TNT 69-18*.

The Proposed Regulations provide that a partnership can only use one method (interim closing or proration) for all Covered Variations in the partners' interests occurring within each partnership taxable year.[29]

The Proposed Regulations also provide rules for determining when during the year the variation in a partner's interest in the partnership is deemed to take place, termed "conventions." The two generally available conventions are the "calendar day convention" and the "semi-monthly convention." Under the semi-monthly convention, any Covered Variation in a partner's interest occurring during the first through the fifteenth day of a calendar month is deemed to occur at the beginning of the first day of the month, and any Covered Variation occurring during the sixteenth day through the last day of the month is deemed to occur at the beginning of the sixteenth day of the month.[30] The Proposed Regulations generally permit the use of the semi-monthly convention only in the case of a partnership that uses the interim closing method.[31]

The calendar day convention can be used in conjunction with the interim closing method and must be used in conjunction with the proration method. Accordingly, a partnership that uses the interim closing method may use either convention, while a partnership that uses the proration method must use the calendar day convention. Under the calendar day convention, any Covered Variation in a partner's interest occurring on a calendar day is deemed effective only as of the beginning of the next calendar day.[32]

The Proposed Regulations provide a special rule for publicly traded partnerships (a "PTP") as defined in Section 7704(b).[33] Under this rule, a PTP using either the interim closing method or the proration method may use either a monthly convention under a consistent method adopted by the partnership, or the semi-monthly convention described above. Under a monthly convention, all transfers of publicly traded units (as described in Treas. Reg. § 1.7704-1(b)(1))[34] during a

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29 Prop. Reg. § 1.706-4(a)(1).

30 Under the Proposed Regulations, this is implemented through the mechanics of the segment rules. *See* Prop. Reg. § 1.706-4(e)(2), which provides that "[u]nder the semi-monthly convention, the first segment of the partnership's taxable year commences with the beginning of the partnership's taxable year, and with respect to a partner's variation in interest occurring on the first through the 15th day of a calendar month, is deemed to close at the end of the last day of the immediately preceding calendar month, and with respect to any variation in interest occurring on the 16th through the last day of a calendar month, is deemed to close at the end of the 15th calendar day of that month."

31 Prop. Reg. § 1.706-4(c)(2), referring to Prop. Reg. § 1.706-4(e)(2). There is an exception to this limitation for publicly traded partnerships. *See* discussion, *infra* Section IV.B.2.

32 Under the Proposed Regulations, this is implemented by ending the current segment as of the close of the date of the Covered Variation and beginning a new segment on the day following the date of the Covered Variation. Prop. Reg. § 1.706-4(e)(1) provides that "[u]nder the calendar day convention, the first segment of the partnership's taxable year commences with the beginning of the partnership's taxable year and ends at the close of any day on which the variation occurs in the partner's interest in the partnership. Any additional segment shall commence with the beginning of the day following a prior variation in a partner's interest and end on the earlier of the close of the day on which an additional variation occurs in the partner's interest or the close of the partnership's taxable year, as applicable."

33 Prop. Reg. § 1.706-4(b)(3).

34 Note that while the Proposed Regulations discuss transfers as defined in Treas. Reg. § 1.7704-1(b)(1), transfers actually are defined in Treas. Reg. § 1.7704-1(a)(3).

calendar month are treated as occurring "for purposes of determining partner status"[35] on the first day of the following month. Block transfers of PTP units as described in Treas. Reg. § 1.7704-1(e)(2) will not qualify for this special rule.

The Proposed Regulations provide that a partnership can use only one convention for all Covered Variations in the partners' interests occurring within each partnership taxable year.[36]

Under the Proposed Regulations, a partnership determines the items of income, gain, loss, deduction and credit allocable to each segment in accordance with the method of accounting that it uses "for the partnership's entire year."[37] The Proposed Regulations provide that, in general, a partnership using the interim closing method will treat each segment as though the segment were a "separate distributive share period."[38] For example, a partnership using the interim closing method may have a net capital loss for a segment even though it has a net capital gain for the entire taxable year.[39] The Proposed Regulations also provide that, in the case of a partnership using an interim closing method, any "limitation applicable to the partnership year as a whole" must be apportioned among the segments using any reasonable method.[40]

As discussed above, a partnership using the proration method must allocate extraordinary items among the partners in proportion to their interests at the beginning of the calendar day on which the items are taken into account by the partnership.[41] The Proposed Regulations define extraordinary items as:

> (i) 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);
>
> (ii) 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);
>
> (iii) Any item from the disposition or abandonment of an asset described in Section 1221(a)(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);

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35 The quoted language appears to provide that the convention applies in the PTP context to determine who is or is not a partner for all purposes of the Code. Similar language is not provided for other conventions, or for partnerships that are not PTPs, in which case the effect of the convention would arguably be more limited (*e.g.*, the interest might be considered transferred on the date of actual acquisition for purposes of determining the holding period of the interest, or for purposes of determining when a deemed termination of the partnership occurs under Section 708(b)(1)(B)).

36 Prop. Reg. § 1.706-4(a)(1).

37 Prop. Reg. § 1.706-4(a)(2)(i).

38 *Id.*

39 *Id.*

40 Prop. Reg. § 1.706-4(a)(2)(ii). The amounts apportioned to segments cannot exceed the overall limitation.

41 Prop. Reg. § 1.706-4(d)(3).

(iv) Any item from assets disposed of in an applicable asset acquisition under Section 1060(c);

(v) Any Section 481(a) adjustment;

(vi) Any item from the discharge or retirement of indebtedness (for example, if a debtor partnership transfers a capital or profits interest in such partnership to a creditor in satisfaction of its recourse or non-recourse indebtedness, any discharge of indebtedness income recognized under Section 108(e)(8) must be allocated among the persons who were partners in the partnership immediately before the discharge);

(vii) Any item from the settlement of a tort or similar third-party liability or payment of a judgment;

(viii) Any credit, to the extent it arises from activities or items that are not ratably allocated (for example, the rehabilitation credit under Section 47, which is based on placement in service); or

(ix) Any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included.[42]

The Proposed Regulations provide an exception to the general varying interest rules for "service partnerships." Under the exception, if there is a change in a partner's interest in a service partnership during a taxable year, the partnership and partner may determine the partner's distributive share of partnership items using any reasonable method to account for the partner's varying interest in the partnership, provided the allocations are valid under Section 704(b).[43] A service partnership is defined as a partnership substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[44]

Finally, the Proposed Regulations provide that the general rules on varying interests will not preclude changes in the allocation of partnership items among contemporaneous partners for the entire partnership taxable year otherwise permitted under Section 761(c),[45] provided that (i) the change is not attributable to a contribution of money or property by a partner to the capital of the

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42 *Id.*

43 Prop. Reg. § 1.706-4(b)(2).

44 *Id.*

45 Section 761(c) provides that a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement. Subject to the varying interest rule of Section 706, this provision generally permits retroactive amendments to the allocation provisions of a partnership agreement, provided that such amendments meet the requirements of Section 761(c) and satisfy the requirements of Section 704(b) (relating to substantial economic effect).

partnership or a distribution of money or property by the partnership to a partner that is a return of capital, and (ii) the resulting allocations satisfy the provisions of Section 704(b) and the regulations thereunder.

The Proposed Regulations are generally effective for taxable years beginning after the later of the date the final regulations are published or December 31, 2009.[46] Prop. Reg. §§ 1.706-4(c)(2) and (d)(2) (relating to permissible conventions), however, will not apply to "existing" publicly traded partnerships."[47]

III. Recommendations

The principal recommendations of this report are as follows:

1. *Use of Multiple Methods During a Taxable Year*. We recommend that the final regulations allow a partnership to use different methods for separate Covered Variations during the partnership's taxable year, provided that the overall combination of methods is reasonable based on the overall facts and circumstances. Alternatively, this approach could be modified by providing that if the interim closing method is used for any Covered Variation during a partnership's taxable year, the date of that Covered Variation would be treated for proration purposes as though it were the end of a partnership taxable year with a new taxable year deemed to begin on the next day. Under this modified approach, the use of the interim closing method for a Covered Variation by one partner would, in effect, close the taxable year of the partnership for all partners for purposes of applying the proration method to segments within the year of the Covered Variation ending on, before, or after the date of that Covered Variation.

2. *Clarification on Availability of Proration Method.* It has been reported that the IRS does not believe that under the Proposed Regulations the proration method is available to a partnership in a taxable year if the partnership has any extraordinary items during that year. We assume that this is not the case, but if it is, then we would urge a reversal of that position.

3. *Use of Any Reasonable Method*. We recommend that the IRS and the Treasury consider designating the proration method and the interim closing method as safe harbors, rather than as exclusive methods, and that the final regulations provide, as a general rule, that a partnership may use as a method any reasonable hybrid of the interim closing method and proration method, provided that (i) such method is reasonable based on the overall facts and circumstances, (ii) the consequences of using such method are consistent with the principles of Section 706, and (iii) a significant purpose of the use of such method is not tax avoidance. For this purpose, a method would be considered consistent with the principles of Section 706 if it

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46 Prop. Reg. § 1.706-4(f).

47 Prop. Reg. § 1.706-4(f) defines "an existing publicly traded partnership" as "a partnership described in section 7704(b) of the Internal Revenue Code that was formed [before April 14, 2009]." However, the Proposed Regulations specifically state that existing PTPs may rely on the provisions of Prop. Reg. § 1.706-4.

represents a hybrid of the interim closing method and the proration method, with the interim closing method applied to some items and the proration method applied to others. A method would not be considered to be inconsistent with the principles of Section 706 merely because of minor variations in the application of the interim closing or proration methods made to address reasonable administrative considerations.

4. *Use of Multiple Conventions for When Variation in Partner's Interest is Deemed to Take Place*. We recommend that the final regulations allow a partnership that uses the interim closing method to use a combination of the semi-monthly convention and the calendar day convention during a taxable year, as long as the combination of conventions is reasonable based on the overall facts and circumstances and a significant purpose of the use of the combination of conventions is not tax avoidance.

5. *Semi-Monthly Convention & "Super Extraordinary Items"*. We recommend that a partnership using the semi-monthly convention that has "super extraordinary items" be permitted to adopt a convention under which such items are allocated using the calendar day convention, while the semi-monthly convention is used for all other items. If this approach is adopted, the definition of "super extraordinary items" should be set at a high amount, which may be determined by reference to the gross value or gross income of the relevant partnership. The IRS and the Treasury should consider whether to require this approach in other cases where the use of the semi-monthly convention results in tax avoidance, with a possible exception for PTPs.

6. *Timing of Extraordinary Items*. We recommend that the final regulations provide that extraordinary items that are properly allocable to the portion of a day after a Covered Variation has occurred would, for purposes of applying Section 706(d), be treated as taken into account by the partnership at the beginning of the following day and accordingly be allocated to the partners in proportion to their respective interests at the beginning of that following day.

7. *Small Item Exception*. To avoid undue administrative burdens when applying the proration method, we recommend that the final regulations provide a "small item" exception from the special treatment of extraordinary items.

8. *Process for Choosing a Method or Convention*. We recommend that the Example of Prop. Reg. § 1.706-4(c)(3) be modified to remove any implication that a partnership may not use a method or convention that is not specifically referenced in the partnership agreement. In addition, if the Treasury accepts our recommendation regarding the allowance of the use of multiple methods during a taxable year, the final regulations should confirm that in the case of a transfer between two partners, it will suffice for the choice of method to be agreed to in writing by the transferee and transferor and consented to in writing by the general partner, manager, or partnership.

9. *Scope of Segments as Separate Distributive Share Periods*. We recommend that the final regulations include a rule that would generally disregard any special limitations

on the timing of deductions or income inclusions for purposes of determining allocations to segments, provided that the conditions for deductibility or income inclusion are satisfied by the end of the partnership's taxable year.

10. *Contemporaneous Partner Exception*. The IRS should consider expanding the contemporaneous partner exception of the Proposed Regulations to cover amendments to allocations (i) among persons that were contemporaneous partners during segments of a taxable year (even if they were not contemporaneous partners during the entire taxable year) and (ii) that involve only items allocable to such segments.

11. *Coordination with Section 704(b)*. We recommend that the final regulations be coordinated specifically with the Section 704(b) regulations so as to confirm that Section 706(d) applies to allocations of Section 704(b) book items (rather than tax items). The allocation of tax items would then follow the allocation of book items in the usual manner, subject to Section 704(c) principles.

12. *Tiered Partnerships*. We recommend that the final regulations provide at least temporary basic guidance on tiered partnership arrangements. The guidance should confirm that an upper tier partnership that has the same taxable year as its lower tier partnership, that holds a fixed percentage interest in the lower tier partnership during a taxable year, and that uses the interim closing method, may determine the items from the lower tier partnership that are allocable to its upper tier partnership segments based on an interim closing method (as of any upper tier partnership segment end) applied to the lower tier partnership. This guidance should also allow an upper tier partnership that has the same taxable year as its lower tier partnership, and holds a fixed percentage in that lower tier partnership during the upper tier partnership's taxable year, generally to prorate the items of the lower tier partnership to each day of the upper tier partnership's taxable year, subject to potential exceptions for the lower tier partnership's extraordinary items. This approach should be allowed regardless of whether the upper tier partnership uses the proration method or the interim closing method with respect to its other items. The regulations relating to tiered partnerships should further provide that any available conventions adopted by the upper tier partnership will be respected for purposes of applying Section 706(d)(2).

IV. Discussion of and Comments on the Proposed Regulations

A. Available Methods

Under the current regulations, there is no prohibition on a partnership using one method for some variations in partners' interests in the partnership during a taxable year and another method for other variations.[48] The Proposed Regulations would limit a partnership to the use of only one

[48] The current regulations provide for a choice of method where a partner sells, exchanges or liquidates its entire interest. *See* Treas. Reg. § 1.706-1(c)(2)(ii). Nothing in the current regulations suggests any limitation on the ability to use different methods for different transfers within the year. Indeed, by focusing on the treatment of a

method for all Covered Variations within a taxable year.[49] For example, under the Proposed Regulations, if a partnership uses the interim closing method for a transfer of an interest in the partnership from partner A to partner B during its 2011 taxable year, it could not use the proration method for a transfer during the same calendar year of an interest in the partnership from partner C to partner D. This limitation would apply both to variations that are complete terminations of a partner's interest in the partnership and to other Covered Variations.

The Preamble gives no indication of why this limitation has been included in the Proposed Regulations, and we believe that it is unnecessarily restrictive. It would seem reasonable for a partnership to be allowed to apply the interim closing method to a transfer of a large interest in the partnership, where the partnership or transferee or transferor partner is willing to pay for the additional accounting costs associated with an interim closing method, and in the same year apply the proration method for transfers of small interests (or other large transfers of interests if, for example, the parties to the transfer are unwilling to bear the costs of a closing of the books), in order to minimize the costs and administrative burden of accounting for such transfers.

In general, we note that, in our experience, the application of Section 706(d) under the current regulations and other guidance provides, in practice, a flexible system that works well and presents little (if any) potential for abuse. There are areas, such as the treatment of tiered arrangements and extraordinary items, that require clarification or guidance, but with those and other limited exceptions, the current system works well. We are concerned that inflexible rules regarding the use of only one method per partnership taxable year, or rules limiting available methods to those specified in the regulations will subject partnerships to unnecessary restrictions that are, in many cases, contrary to current practice.

In this regard, we recommend that the final regulations allow a partnership to use different methods for separate Covered Variations during the partnership's taxable year, provided that the overall combination of methods is reasonable based on the overall facts and circumstances.[50]

> <u>Example 1</u>: P is a partnership.[51] On January 31, 2011, A transfers a 1% interest in P to B. On June 30, 2011, C transfers a 30% interest in P to D. A, B and P do not want to pay the costs of an interim closing of the books in respect of the January 31 transfer. C agrees to pay the administrative and accounting costs of an interim closing of the books in respect of the June 30 transfer.

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particular partner, the regulations appear to sanction the use of multiple methods where there are multiple transfers within the partnership taxable year.

49 Prop. Reg. § 1.706-4(a). It appears, but is not completely clear, that this limitation would not apply to "service partnerships," due to the greater flexibility provided for such partnerships under Prop. Reg. § 1.706-4(b)(2).

50 A possible restriction would be to require that the same method be used for all Covered Variations that occur (or are deemed to occur under a convention) on the same day, on the grounds that once the administrative costs of an interim closing of the books have been incurred for one of the Covered Variations on that date, the incremental costs of applying that method to other Covered Variations on that date generally would be small. Note that even if the use of multiple methods for same day Covered Variations is not administratively justified in a particular context, we believe the IRS should be adequately protected by the general reasonableness requirement for combinations of methods suggested above.

51 References to "P" in this Report are to a partnership unless otherwise indicated.

Under the Proposed Regulations, P would have to use either the interim closing method or proration method for both transfers. P generally should be allowed to use the interim closing method with respect to the June 30 transfer and the proration method with respect to the January 31 transfer.

If this suggestion is adopted, an example should be included of a situation in which there are multiple transfers of (or other variations with respect to) the same interest during the taxable year, and multiple methods are used. The example would illustrate that a combination of methods is reasonable only if the combination results in each item of distributive share with respect to such interest being taken into account once and only once by the partners.[52]

> Example 2: P, which uses the calendar day convention, has $1000 of taxable income for the period January 1, 2011 through April 30, 2011; $1000 of taxable loss for the period May 1, 2011 through August 31, 2011; and $1000 of taxable income for the period September 1, 2011 through December 31, 2011. A has a 10% interest in P and transfers that interest to B on April 30, 2011. B in turn transfers that interest to C on August 31, 2011. C holds the interest through the end of the year. If the interim closing method is used for the transfer from A to B, it would be reasonable to apply the proration method for the transfer from B to C, only if the proration is limited to items for the portion of the taxable year after April 30, 2011.[53] Accordingly, A's distributive share of P's taxable income would be $100, B and C's distributive shares for the portion of the taxable year after April 30, 2011 would be $0, and the total of the distributive shares included by A, B and C for the taxable year with respect to the 10% interest would be $100, which is the distributive share of the 10% interest for the entire taxable year. A reasonable result would not be obtained if C's distributive share of items was determined on the basis of proration for the entire 2011 year, as that would result in some partnership items being included in income more than once.

A variant on our recommendation, which would automatically address the issue raised in Example 2, but provide less flexibility, would be to allow a partnership to use a combination of the interim closing and proration methods during a taxable year, but would require that if the interim closing method is used for any Covered Variation during the partnership's taxable year, the date of that Covered Variation would be treated for proration purposes, as applied to other Covered Variations during that year, as though it were the end of a partnership taxable year with a new taxable year deemed to begin on the next day. Under this modified approach, the use of the interim closing method for a Covered Variation during a partnership year by one partner would, in effect, close the taxable year of the partnership for all partners for purposes of applying

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52 A statement to this effect could also be included as part of the requirement that if multiple methods are used, then the combination of methods must be reasonable.

53 If the interim closing method is used for the transfer from A to B, it also would be reasonable to use the interim closing method for the transfer from B to C. Additionally, using the interim closing method for both transfers would not raise any concerns about all items allocable to the transferred interest being taken into account once and only once. If the interim closing method were used for both transfers in Example 2, A's and C's distributive shares of taxable income would be $100, and B's distributive share would be a taxable loss of $100.

the proration method to partnership items attributable to segments of that year ending on, before or after the date of the Covered Variation.

Applying this variant to the facts of Example 2, if the interim closing method is applied with respect to the transfer from A to B (that is, for the segment from January 1, 2011 through April 30, 2011), the proration method would not be available, for any partners, for items attributable to that segment, but would be available for all partners for items attributable to the remaining segments of the partnership's 2011 taxable year (assuming the interim closing method was not used for any segments of the 2011 taxable year ending after April 30, 2011). Accordingly, if on the facts of Example 2, on August 31, 2011 D transferred a 15% interest in the same partnership to E, and assuming no other Covered Variations (other than the transfer from A to B) during the taxable year, the two methods that would be available for apportioning items attributable to the transferred interest for 2011 between D and E would be (i) an interim closing method pursuant to which D would take into account all items for the segments ending on or before August 31, 2011 and no items attributable to the remaining segment of the year, which would result in $0 of income for D and $150 of income for E, or (ii) an interim closing method for the segment ending April 30, 2011, and a proration method for the remaining segments of the year, which would result in $150 of income for D and $0 of income for E.[54]

This variant would address most of our concerns regarding burdensome accounting and administrative costs of requiring the interim closing method to be used for all Covered Variations during a taxable year if it is used for any Covered Variation during the taxable year, as discussed above. It would, however, have the effect of subjecting all partners to a decision (to use the interim closing method) made with respect to a particular partner's Covered Variation.

The Proposed Regulations seem to clearly contemplate that a partnership may use the proration method for a taxable year, even if the partnership has extraordinary items for that year. In such a case, proration would not apply to extraordinary items, which instead would be allocated among the partners in proportion to their interests at the beginning of the calendar day on which the extraordinary items were taken into account by the partnership.[55] Nevertheless, it has been reported that the government does not believe that under the Proposed Regulations the proration method is available to a partnership in a taxable year if the partnership has any extraordinary items during that year.[56] We assume that this is not the case, but if it is, then we would urge a reversal of that position because (i) it is unjustified in light of the special treatment of extraordinary items under the proration method in the Proposed Regulations, and (ii) it would

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54 More technically, we propose that if the interim closing method is used for a segment or segments, proration would be limited to items in contiguous segments on either side of the interim closing date. Thus, if there are segments 1-5 during a taxable year (in that time sequence), and interim closing is used for a transaction that terminates segment 3, the items from segments 1, 2, and 3 could be prorated over the period covered by those segments, and items from segments 4 and 5 could be prorated over the period covered by those segments; but items from periods 1, 2, and 3 could not be prorated over segments 4 and 5, and vice versa.

55 Prop. Reg. § 1.706-4(d)(3).

56 Paul D. Carman, *The Section 706 Prop. Regs.: A Mechanical Rule With Surprises (and Questions)*, 111 J. TAX'N 33, 36 n.11 (July 2009) (citing a May 8, 2009 American Bar Association panel discussion at which a government representative stated that this was the government's position).

preclude the use of the proration method in too many cases, given the broad definition of extraordinary items.

We understand that, in current practice, most PTPs that use the proration method use a hybrid method to account for depreciation with respect to an asset that is sold or acquired during the taxable year. Under this method, depreciation with respect to the asset for the year of acquisition or disposition is prorated only over the months during which the asset is owned by the partnership and the prorated amounts are allocated based on the partners' interests in the partnership during those months. We note that unless additional flexibility is provided in final regulations, this hybrid method, which as to depreciation appears more equitable, would not be permitted.

We also understand that most PTPs that use the proration method and a monthly convention,[57] for administrative convenience, prorate by apportioning 1/12 of the non-extraordinary items of the PTP to each calendar month, rather than by effecting the apportionment based on the actual number of days in each month.

As noted above, in our experience, the application of Section 706(d) under the current regulations and other guidance provides, in practice, a flexible system that works well and presents little (if any) potential for abuse. We are concerned that inflexible rules will subject partnerships to unnecessary restrictions that are, in many cases, contrary to current practice.

In view of current practice, we recommend that the Treasury consider designating the proration method and the interim closing method as safe harbors, rather than as exclusive methods, and that the final regulations provide, as a general rule, that a partnership may use as a method any reasonable hybrid of the interim closing method and proration method, provided that (i) such method is reasonable based on the overall facts and circumstances,[58] (ii) the consequences of using such method are consistent with the principles of Section 706, and (iii) a significant purpose of the use of the hybrid method is not tax avoidance.[59] For this purpose, a method would be considered consistent with the principles of Section 706 if it represents a hybrid of the interim closing method and the proration method, with the interim closing method applied to some items and the proration method applied to others. A method would not be considered to be inconsistent with the principles of Section 706 merely because of minor variations in the application of the interim closing or proration methods made to address reasonable administrative considerations.

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57 See Section IV.B.3., *infra*, for a discussion of the monthly convention used by PTPs.

58 The reasonableness standard should include the requirement that each partnership item is allocated to one and only one partner during the partnership taxable year. In addition, for example, in the case of a method that was principally a proration method, to satisfy the reasonable requirement, variations from proration, aside from extraordinary items, would presumably have to be justified on some significant non-tax basis, such as that they are appropriate to reflect more accurately the economics (*e.g.*, depreciation with respect to a major property allocated only to segments when the property is in service). A method under which all profit items are prorated, but all loss or deduction items are allocated on an interim closing method, would generally not be reasonable.

59 A significant tax avoidance purpose might be presumed if the use of the method results in a significant reduction in the partners' aggregate tax liability for the taxable year, as compared to what such tax liability would have been under the interim closing or proration methods (whichever would produce the lower overall tax liability).

B. Available Conventions

1. The Semi-Monthly Convention and Extraordinary Items: Combinations of Conventions

The Proposed Regulations provide that a partnership using the interim closing method may use the semi-monthly convention.[60] Under the semi-monthly convention, Covered Variations occurring during the first through the fifteenth day of a calendar month are deemed to occur on the last day of the preceding calendar month, and Covered Variations during the sixteenth day of the month through the end of the month are deemed to occur at the close of the fifteenth day of the month.

The Proposed Regulations do not provide any special rules for "extraordinary items" applicable to partnerships that use the semi-monthly convention. This could lead to inappropriate adverse results for taxpayers in some cases.

> Example 3: P uses the interim closing method and semi-monthly convention for calendar year 2011. On November 16, 2011, $100 of P's outstanding debt is modified in a manner that causes P to recognize $25 of cancellation of indebtedness ("COD") income. On November 20, 2011, A sells a 10% interest in P to B. Under the semi-monthly convention, B will be deemed to have become a 10% partner in P on November 16. As a result, B will be required to include in income a 10% distributive share of the COD income,[61] even though B did not purchase its interest until after the COD had been realized.[62]

B could have avoided the result of Example 3 by delaying its purchase until after November 30, 2011, but this is not always practicable. The result also could have been avoided if P had used the calendar day convention for 2011. However, A and B may have no control over the choice of convention—P may have selected the semi-monthly convention, for example, because of large numbers of Covered Variations that occurred earlier in the year. Under the Proposed Regulations, a partnership may use only one convention per taxable year,[63] and accordingly P could not use the semi-monthly convention for its other transfers and the calendar day convention for the transfer from A to B.

As discussed above, one approach for addressing the result in Example 3 would be to allow a partnership to use more than one convention per taxable year, so that, for example, the transfer

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60 Prop. Reg. § 1.706-4(c)(2).

61 Example 3 assumes that P is required to recognize the COD income and that no exception to the recognition of the income is available to B.

62 The issue presented in Example 3 would be mitigated in a case where an extraordinary item is gain with respect to "property" and P has an election in effect under Section 754 of the Code. In such a case, B would have the benefit of a Section 743 step-up to offset the gain. Example 3 assumes that a Section 743(b) adjustment would not be available to offset COD income (although some tax advisors take the contrary position). Other extraordinary items that may not be covered by Section 743(b) adjustments are tort recoveries and Section 481 adjustments.

63 Prop. Reg. § 1.706-4(a)(1).

from A to B could use the calendar day convention even if other transfers during the year use the semi-monthly convention. As in the case of methods, we believe it would be reasonable to allow a partnership to use multiple conventions during the taxable year as long as the combination of conventions is reasonable under the facts and circumstances and tax avoidance is not a significant purpose for the use of multiple conventions.[64] For example, the semi-monthly convention might be used for small transfers, while the calendar day convention might be used for large transfers where the parties are willing to bear the administrative expense of an interim closing of the partnership books as of the actual transfer date.

We recommend that the final regulations allow a partnership that uses the interim closing method to use a combination of the semi-monthly convention and the calendar day convention during a taxable year, as long as the combination of conventions is reasonable based on the overall facts and circumstances and a significant purpose of the use of the combination of conventions is not tax avoidance.

The lack of any special rules for "extraordinary items" in respect of partnerships that use the interim closing method and semi-monthly convention also presents at least a theoretical potential for tax avoidance.

> <u>Example 4</u>. The facts are the same as in Example 3, except that B is a foreign person that is not subject to tax on the COD income,[65] or B has a large net operating loss carry-forward that is about to expire. A could affirmatively use the semi-monthly convention to avoid the COD income.[66]

In this regard, consideration might be given to including a limitation on the use of conventions, other than the calendar day convention, to the effect that they can only be used if the results of their use are reasonable, taking into account the overall facts and circumstances. The final regulations might also (or alternatively) provide an example, similar to Example 4, which concludes that the result in that example is not reasonable, and hence the semi-monthly convention cannot be used. That said, we are not aware of abusive use of conventions, nor do we believe that the semi-monthly convention as a practical matter presents a significant potential for abuse. In this regard, we note that the same result as Example 4 could be achieved, without the use of the convention, if A were to sell the interest in P to B shortly before the recognition by

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64 A significant tax avoidance purpose might be presumed if the use of multiple conventions results in a significant reduction in the partners' aggregate tax liability for the taxable year, as compared to what such tax liability would have been if only the semi-monthly or calendar day convention had been used for all Covered Variations during the taxable year (whichever produced the lower overall tax liability). See also the discussion *supra* note 59, with respect to a similar standard for presumed tax avoidance for hybrid methods.

65 *E.g.*, because the particular COD income is not effectively connected with a U.S. trade or business within the meaning of Section 864.

66 However, as a result of avoiding the COD income, A would generally have a larger capital gain or smaller loss on the sale of the partnership interests (*i.e.*, a character difference). Similar issues can arise in cases where P has assets with large built-in gain or loss, particularly where P has no Section 754 election in effect. However, the abuse potential in that case is mitigated by the effect of Section 751(a) and the requirement of mandatory Section 743(b) adjustments where P has a substantial built-in loss in its assets within the meaning of Section 743(d).

P of the COD income.[67] Thus, the result illustrated by Example 4 could have been easily achieved in many cases without the use of the convention.[68]

An alternative approach to address the concerns about inappropriate adverse results for taxpayers or potential abuse arising from extraordinary items under the semi-monthly conventions would be to provide a special rule for "super extraordinary items" that allows (or with respect to a case that results in tax avoidance requires) "super extraordinary items" to be allocated using the calendar day convention while the semi-monthly convention is used for all other items.

> Example 5: Assume the same facts as in Example 3. Under this alternative, B is considered to become a partner in P as of the beginning of November 16, 2011 with respect to all P items other than the COD income, and the calendar day convention would apply to the COD income, so the COD income with respect to the transferred interest is allocated to A rather than to B.

We recommend that this hybrid convention be available on a permissive basis to all partnerships with respect to "super extraordinary items," to avoid unfairness. The IRS and the Treasury should consider whether to require this approach in other cases where the use of the semi-monthly convention results in tax avoidance, with a possible exception for PTPs. If this approach is adopted, the definition of "super extraordinary items" should be set at a high amount, which may be determined by reference to the gross value or gross income of the relevant partnership. Making this hybrid convention available would be particularly important if our recommendation regarding allowing a combination of conventions to be used is not adopted. However, even if our recommendation regarding allowing a combination of conventions to be used is adopted, also allowing the use of this hybrid convention would be justified based on considerations of administrative and tax accounting costs that could be avoided through the use of the semi-monthly convention applied to all items that are not super extraordinary.

2. The Semi-Monthly Convention and the Proration Method

The Proposed Regulations generally do not permit partnerships that use the proration method to use a semi-monthly convention; those partnerships must use the calendar day convention.[69] As a result, in the case of a partnership that both uses the proration method and has extraordinary items, such items would have to be accounted for based on the partners' respective interests in

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[67] In that case, arguably other doctrines, such as assignment of income, might apply to require the COD income to be allocated to A. The same doctrines might be applied if the convention were used. *See* Treas. Reg. § 1.704-1(b)(1)(iii) (noting the effect of other sections in the context of Section 704(b) allocations and referencing, among other doctrines, assignment of income).

[68] The potential for shifting recognized losses and deductions (as opposed to gain and income items) to a transferee through use of the semi-monthly convention has been reduced, but not eliminated, by various specific rules under the Code, including the rule for mandatory Section 743(b) adjustments where a partnership has a "substantial built-in loss" and the cash basis item rules of Section 706(d)(2). The potential for shifting still exists, however, with respect to, among other things, loss items that potentially are not subject to Section 743(b) adjustments (*e.g.*, tort losses and Section 481 adjustments).

[69] Prop. Reg. § 1.706-4(d)(2).

the partnership at the beginning of the day on which the items are taken into account by the partnership.[70]

The Proposed Regulations provide an exception to this limitation for PTPs, which are permitted to use the proration method in combination with the semi-monthly and monthly conventions.[71] We understand that this exception generally comports with current practice of such PTPs. That is, most such PTPs (i) apportion their non-extraordinary items pro rata to each month and allocate the amount of such items apportioned to the month to those persons that were partners on the first day of the month, and (ii) allocate any extraordinary items for the month to the persons that were partners on the first day of the month.

> <u>Example 6</u>: P is a PTP that uses the monthly convention and the proration method. P has $1,200 of taxable income for the year (determined without regard to extraordinary items) and $300 of taxable gain from the sale of property that it recognizes on June 20. P will typically apportion $100 of the non-extraordinary income to each calendar month and allocate it to the persons that were partners on the first day of each calendar month, in proportion to their interests in P on each such day. P will allocate the $300 of taxable gain to the persons that were partners on June 1 in proportion to their interests in P on June 1.

It would be administratively useful to partnerships, other than just PTPs, with many Covered Variations during a taxable year to be able to use a semi-monthly convention in conjunction with the proration method, in the same manner as PTPs, to avoid having to account for relatively small extraordinary items on a day by day basis.[72] If the semi-monthly convention was generally permitted to be used in conjunction with the proration method, its use would raise analogous issues to those discussed above in connection with the use of the semi-monthly convention by partnerships that use the interim closing method where there are large extraordinary items (as to potential limitations on the use of the semi-monthly convention or special treatment of "super extraordinary items").

3. The Monthly Convention

With respect to publicly traded units of PTPs,[73] the Proposed Regulations allow use of a monthly convention under which all transfers made during the month are considered as made on the first day of the following month provided that such method "is consistently applied."[74] We question

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70 Prop. Reg. § 1.706-4(d)(3).

71 Prop. Reg. § 1.706-4(b)(3).

72 This concern would be mitigated if our recommendation regarding a small items exception to the rules for extraordinary items is adopted. *See* discussion, Section IV.F, *infra*.

73 Prop. Reg. § 1.706-4(b)(3). The special rules apply to publicly traded units (as defined in Treas. Reg. § 1.7704-1(b)(1)) of PTPs as defined in Section 7704. Note that while the Proposed Regulations discuss transfers as defined in Treas. Reg. § 1.7704-1(b)(1), transfers are actually defined in Treas. Reg. § 1.7704-1(a)(3). The special rules do not apply to "block transfers" of PTP units as defined in Treas. Reg. § 1.7704-1(e)(2) (generally, transfers of more than 2% of the interests in the PTP).

74 Prop. Reg. § 1.706-4(b)(3). Unlike the approach of the semi-monthly convention, this convention causes variations that occur during a month to be deemed to occur later in time (*i.e.*, as of the beginning of the next month).

why the monthly convention is not also made available outside the PTP context. Note in this regard that the Conference Report to the 1984 Act states that "[w]ith respect to the monthly convention, the conferees understand that the Secretary will provide a monthly convention by regulations; thus, the statutory provision adopted by the Senate is unnecessary."[75]

C. Next Day Rule for Certain Extraordinary Items

Under the Proposed Regulations, a partnership that uses the proration method must separately account for "extraordinary items" and allocate such items among the partners in proportion to their interests *at the beginning of the calendar day* on which they are taken into account by the partnership.[76] If a partnership uses the interim closing method, extraordinary items are treated like all other items and are allocated in accordance with the partners' interests in the partnership during the segment in which the extraordinary items are taken into account by the partnership. Thus, if a partnership that uses the interim closing method and the calendar day convention recognizes an extraordinary item on the last day of a segment, such item is allocated, as in the case of the proration method, to the partners in proportion to their interests at the beginning of that calendar day (because segments do not bifurcate calendar days). Accordingly, under both methods, if a partnership interest is transferred on a given date, and an extraordinary item is recognized by the partnership after the transfer, but on the transfer date, the Proposed Regulations appear to require the item to be allocated to the transferor partner. This will be the result regardless of whether the transferor partner was aware of or consented to the transaction giving rise to the post-transfer extraordinary item.

> Example 7: A owns a 10% interest in P and transfers that interest to C, the majority owner and general partner of P, on February 20, 2011. Following the transfer on the same date, C acquires P debt at a discount, resulting in $100,000 of COD income to P pursuant to Section 108(e)(4).[77] P uses the proration method for 2011. Under Prop. Reg. § 1.706-4(d)(3), $10,000 of the COD income in respect of the transferred interest would be allocated to A. The same result would be obtained if P uses the interim closing method.[78]

It would seem more appropriate, in Example 7, to allocate $10,000 of COD income to C and none to A. This is true particularly if A was not involved with and did not consent to the transaction giving rise to the COD. This is the result that would be obtained in the consolidated return context, under the rule of Treas. Reg. § 1.1502-76(b)(2)(B) (the "next day rule") and under a similar next day rule in the context of a Section 338 election.[79] Under the next day rule of the consolidated return regulations, if, on the day of a subsidiary's change of status, a

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[75] 1984 Conference Report, *supra* note 14. The monthly convention described in the Conference Report contemplated that partners entering after the fifteenth day of a month would be treated as entering on the first day of the following month and partners entering during the first fifteen days of a month would be treated as entering on the first day of the month. The 1984 Joint Committee Report, however, included among its list of possible conventions a monthly convention similar to that in the Proposed Regulations.

[76] Prop. Reg. § 1.706-4(d)(3).

[77] Under Section 108(e)(4), P will recognize COD income if C is a related to P and acquires P debt at a discount from a person unrelated to P.

[78] The P segment that includes February 20, 2011 would end as of the close of that date.

[79] Treas. Reg. § 1.338-1(d).

transaction occurs that is "properly allocable" to the portion of the subsidiary's day after the event that results in the change, the transaction is treated as occurring at the beginning of the following day.

We recommend that the final regulations provide that extraordinary items that are properly allocable to the portion of a day after a Covered Variation has occurred would, for purposes of applying Section 706(d), be treated as taken into account by the partnership at the beginning of the following day and accordingly be allocated to the partners in proportion to their respective interests at the beginning of that following day.

D. Segments as Separate Distributive Share Periods

Prop. Reg. § 1.706-4(a)(2) provides that:

> The partnership shall determine the items of income, gain, loss, deduction and credit of the partnership for each segment in accordance with the method of accounting that it uses for the partnership's entire taxable year. In general, a partnership using the interim closing method shall treat each segment as though the segment were a separate distributive share period. For example, a partnership using the interim closing method may compute a net capital loss for a segment of a taxable year even though the partnership has a net capital gain for the entire taxable year. (Emphasis added.)

An issue arises as to the scope of the separate "distributive share period" concept. It seems clear that this concept is limited to Section 706 computations, so that it could not be read to affect the amount of the partnership's items of income, gain, loss, and deduction, but only their allocation among partners where there are Covered Variations during the partnership's taxable year. In that context, the question is to what extent the "distributive share period" is treated as though it were a separate taxable year? For example, could the economic performance provisions of Section 461(h) change the allocation of deductions between segments, or could the application of Section 404(a)(5) and Treas. Reg. § 1.404(a)-(12)(b)(1) with respect to the timing of compensation deductions affect the allocation of such deductions between segments?[80]

We recommend that the final regulations include a rule that would generally disregard any special limitations, such as those contained in Section 461(h) and 404(a)(5), on the timing of deductions or income inclusions for purposes of determining allocations to segments, provided that conditions for deductibility or income inclusion are satisfied by the end of the partnership's taxable year.

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80 Section 404(a)(5) and Treas. Reg. § 1.404(a)-(12)(b)(1) provide that a compensation deduction will be allowed to an employer "only in the taxable year of the employer in which or with which ends the taxable year of the employee in which an amount attributable to such contribution [payment] is includible in his gross income as compensation."

E. Annual Items/Period Costs/Exceptions to Proration

The Proposed Regulations provide, in the context of the proration method, that "specific items that are aggregated by the partnership at the end of the year (other than extraordinary items…) shall be disregarded, and the aggregate of the items shall be considered to be the partnership item for the year."[81] It is unclear what types of items this provision is intended to cover, or what the effect of this provision would be on the allocation of those items. If such items are considered to be "partnership items for the year," that would seem to imply that those items should be prorated under the normal proration rules. It would be helpful if the final regulations clarify what items are intended to be covered by this provision and what the effect of the provision would be on the allocation of such items.

The Proposed Regulations do not contain a similar rule for the interim closing method. They do, however, contain a different rule to the effect that "[a]ny limitation applicable to the partnership year as a whole (for example, the limitation under Section 179, relating to elections to expense certain depreciable business assets) must be in connection with the interim closing method apportioned among the segments by the partnership using any reasonable method, provided, however, that the amounts apportioned among segments shall not exceed the limitation applicable to the partnership as a whole."[82] Query whether this "limitation" rule for the interim closing method and the "aggregated specific items" rule for the proration method were intended to cover similar ground. Are there "annual" items of a partnership (other than just limitations) that should be required or allowed to be prorated when the interim closing method is used?

One issue with segment accounting is the proper allocation among segments of ACRS deductions under Section 168 with respect to property placed in service or disposed of by the partnership during the partnership's taxable year. Under Section 168, such deductions are computed by taking into account the "applicable convention" that deems the property placed in service, or disposed of, at a specified date.[83] For example, if the half-year convention applies, property placed in service during a taxable year is treated as placed in service (or disposed of) at the midpoint of such taxable year. Presumably, if there were no such convention, depreciation for property placed in service during the taxable year would be allocated (absent adoption of the proration method) in some appropriate manner only among those segments that included days on which the partnership actually owned the property. However, if the half-year convention applies with respect to property placed in service by a partnership during a taxable year, is any of the partnership's ACRS deduction for the year allocable to segments ending before mid-year? Does it matter whether the property is actually placed in service before mid-year (*e.g.*, on January 31)?[84] If the property is placed in service on September 15, is any of the ACRS deduction allocable to a segment that ends August 31 (and, if so, how much), or is all the depreciation allocable to segments that begin on or include September 15?

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81 Prop. Reg. § 1.706-4(d)(1).

82 Prop. Reg. § 1.706-4(a)(2)(ii).

83 Section 169(d)(4)(A). The half-year convention applies generally to property other than real property.

84 Arguably, the convention should apply only to determine the amount of partnership depreciation for the taxable year and depreciation should be allocated among the segments based on the partnership's actual ownership of the property.

Another potential issue with segment allocation is the treatment of allocation of "indirect costs," such as indirect costs required to be allocated to inventory, or cost of goods sold under the full absorption method of Section 471, that are period costs, but are often allocated on other than a period basis. The regulations should include a provision to the effect that the good faith (and consistent) application of the normal rules of Section 471, or other relevant tax accounting rules, for determining the proper short-period in which to allocate period items that are indirect costs will be respected for purposes of allocating such items among segments.[85]

F. Definition of Extraordinary Items

The Proposed Regulations define extraordinary items to include, among other things, any gains or losses from dispositions of capital assets and Section 1231 assets, cancellation of indebtedness income, Section 481 adjustments,[86] and items from the settlement of a tort or similar liability or payment of a judgment.[87] No small item exception is provided for the classification of items as extraordinary.

To avoid undue administrative burdens when applying the proration method, we recommend that the final regulations provide a small item exception from the special treatment of extraordinary items. The threshold might be a per item amount, or a cumulative amount, for example, $100,000, or might vary depending on the size of the partnership or whether the partnership was a PTP.

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85 For example, under the full absorption method for determining inventory costs, the rental cost of a manufacturing facility is usually not allocated on a period basis, even though each monthly rental is equal. Typically, an anticipated production run (denominated in number of output units) is projected at the beginning of the year. The annual rent is then allocated based on the projected number of output units for the year and reflected as an inventory cost. For the full year, the amount of rent allocated to cost of goods sold would depend in part on how much of the annual production was sold in the year versus the amount constituting inventory at year end. In addition, typically at the end of the year, the actual production will have differed somewhat (or a lot) from the projected figure. This "variance" is then either written off entirely as a positive or negative adjustment to cost of goods sold (*i.e.*, expense or contra-expense item) or is allocated to cost of goods sold and ending inventory based on the relative size of those balances. In such circumstances, "cutting off" a year part way through raises issues regarding how to account for, among other things, end-of period adjustments for variances.

86 The treatment of Section 481 adjustments is unclear under current law and from a policy perspective where partnership interests vary and the Section 481 adjustment is spread forward by a partnership over multiple years. As an initial matter, it is unclear whether the entire Section 481 item is allocated to the partners in the taxable year the adjustment occurs and is then taken into account solely at the partner level in subsequent years. *See* Treas. Reg. § 1.481-2(c)(5)(i). If this is not the case, then if, for example, a Section 481 adjustment to income of a partnership in year 1 is spread forward to years 2 and 3, it is unclear whether, under current law, the income from the adjustment in years 2 and 3 should be allocated in accordance with the interests of the partners in those years, or in some manner based on their interests in year 1. If the Section 481 adjustment income includible in years 2 and 3 is to be allocated in accordance with the partners' interests in the partnership in those years, then consideration should be given to deleting Section 481 adjustments from the list of extraordinary items, and instead treating Section 481 adjustment income as an annual item that is to be prorated over the year in which it is recognized by the partnership.

87 *See* Section II., *supra*, for a complete list of extraordinary items. Note that the list of extraordinary items is a subset of the list of extraordinary items that are excluded from proration under Treas. Reg. § 1.1502-76(b)(2)(ii)(C).

G. Selection of Methods and Conventions

The Proposed Regulations provide that a partnership may "by agreement of the partners" use the proration method.[88] They also provide that a partnership using the interim closing method may use either the calendar day convention or the semi-monthly convention.[89] The example in Prop. Reg. § 1.706-4(c)(3), which involves transfer of an interest in a partnership from partner S to partner Y, states that because the partnership has "no specific provision in the partnership agreement relating to which section 706 method to use with regard to varying interests," the partnership will be required to use the interim closing method. This suggests that in order to use the proration method, either the partnership agreement would have to include a specific provision regarding its use, or the general partner would have to be given specific authority to adopt a Section 706 method.

We do not believe that the selection of method or convention should be required to be specifically set forth in the partnership agreement.[90] In cases where a Covered Variation is caused by a transaction between the partnership and one or more partners (*e.g.*, a partner receiving an interest from the partnership as a result of a contribution of cash, property or services, or a partner having a portion of its interest in the partnership redeemed), it should suffice that the partnership agreement authorizes the partnership, or its general partner or manager, to select the Section 706 method or convention to be used, or make tax elections generally without specific reference to Section 706. In cases where the Covered Variation is a transfer between partners, it should suffice that those partners agree in writing to the use of a particular method (or convention) and that the general partner/manager, or the partnership, provides written consent to its use for a transfer (subject to any limitation on the ability to use multiple methods or conventions during a taxable year). Note that the advisability of permitting a transferee and transferor partner to agree among themselves to a method will obviously depend on whether the Treasury accepts our recommendation regarding the allowance of more than one method to be used during a taxable year.

We recommend that the Example of Prop. Reg. § 1.706-4(c)(3) be modified to remove any implication that a partnership may not use a method or convention that is not referenced specifically in the partnership agreement. In addition, if the Treasury accepts our recommendation regarding the allowance of the use of multiple methods during a taxable year, the final regulations should confirm that in the case of a transfer between two partners, it will suffice for the choice of method to be agreed to in writing by the transferee and transferor and consented to in writing by the general partner, manager, or the partnership.[91]

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88 Prop. Reg. § 1.706-4(d)(1).

89 Prop. Reg. § 1.706-4(c)(2).

90 Note that under Treas. Reg. § 1.761-1(c), for purposes of subchapter K, a partnership agreement includes any modification thereof agreed to by all of the partners or adopted in any other manner provided in the partnership agreement. *See also* Treas. Reg. § 1.704-1(b)(2)(ii)(h) (defining partnership agreement for purposes of Treas. Reg. § 1.704-1(b) as including all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement).

91 The final regulations might require that the written agreement and consents be provided before the due date of the partnership's tax return (determined without regard to extensions), in effect subjecting the choice of method to the partnership amendment rules of Section 761(c). Alternatively, the final regulations might provide that the

H. Contemporaneous Partners

The Proposed Regulations provide that the varying interest rule of Section 706(d) will not preclude giving retroactive effect to changes in allocations among contemporaneous partners for the entire partnership taxable year resulting from amendments to a partnership agreement made not later than the due date for the partnership's tax return for the taxable year (determined without regard to extensions);[92] provided that (i) the change is not attributable to a contribution of money or property to the capital of the partnership or a distribution of money or property by the partnership to a partner that is a return of capital, and (ii) the allocations resulting from the modification have substantial economic effect under the Section 704(b) regulations.[93] This rule (hereinafter the "CP Exception") applies only to Covered Variations that are not dispositions of a partner's entire interest in the partnership.[94]

The Proposed Regulations provide no guidance as to how the determination of whether and to what extent an amended allocation is attributable to a capital contribution or a return of capital distribution is to be made. Presumably the determination would be made on the basis of the relevant facts and circumstances. In addition, it is not clear how to determine in the general case whether a particular partnership distribution is a return of capital.[95] Providing rules to distinguish a return of capital distribution from a distribution of profits in the context of a complex partnership arrangement presents very difficult technical issues.[96]

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written agreement and consents need only be obtained before partnership's tax return is filed, in effect, providing the same timing rule that would apply if the partnership had chosen the method pursuant to its general power to choose methods provided under the partnership agreement.

92 This is in accordance with the rule of Section 761(c), which defines a partnership agreement to include any modifications prior to the due date of the return (determined without extensions) that are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement. See the discussion in Section I, *supra*, and its reference to the 1984 Joint Committee Report, which states that the 1984 Act's adoption of Section 706(d) was not intended to override the rule of Section 761(c) with respect to interest shifts among partners who are partners for the entire year, provided that the shifts are not attributable to the influx of new capital, and citing *Lipke v. Comm'r,* 81 T.C. 689 (1983).

93 Prop. Reg. § 1.706-4(b)(1).

94 It covers only variations described in Prop. Reg. §1.706-1(c)(3) (dispositions of less than an entire interest). This is presumably because if there is a variation described in Prop. Reg. § 1.706-1(c)(2) (disposition of an entire interest) the partner whose interest is terminated is not a contemporaneous partner for the entire year.

95 A similar issue is also present in Treas. Reg. § 1.706-1(c)(3) [presently (c)(4)], which keys off a "reduction" in a partner's interest, which then triggers a segment end. When is a distribution a reduction? *See also* Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5) (revaluations of partnership property in connection with a distribution of money or property as consideration for an interest in the partnership).

96 Is a distribution of retained earnings from prior years attributable to a partnership interest a return of capital? Would it matter if the distribution was not of retained earnings, but instead of gain booked into the capital account on a revaluation in the prior year? This issue is addressed for partnerships in the "fractions rule context" by Treas. Reg. § 1.514(c)-2(d)(5)(ii) (defining "return of capital"). That regulation provides that the designation of distributions in a written partnership agreement generally will be respected in determining whether a distribution constitutes a return of capital, so long as the designation is economically reasonable. However, requiring specific provisions to distinguish profits distributions from return of capital distributions be included in a partnership agreement for this purpose would be unwarranted and would add complexity to the drafting of partnership agreements.

As noted above, the CP Exception applies only to changes in allocations among contemporaneous partners for the entire partnership taxable year. Consider a situation in which A and B are partners in P for the entire taxable year and in which C, who is to provide services, joins the partnership (with no capital contribution) mid-year. A and B initially each have a 50% share of partnership profits. C has a 10% profit share from the date of his or her admission (which dilutes A's and B's interests to 45% each). Assume that at the end of the year the partnership agreement is amended to reallocate the year's profits (i) for the period up to C's admission 35% to A and 65% to B, and (ii) for the period from and after C's admission 30% to A, 50% to B and 20% to C. To what extent is the amendment covered by the CP provision? Presumably it would apply (i) to the change in allocations for the first segment that ends on C's admission, and (ii) to the 5% shift in profits in respect of the second segment from A to B, but not to the 10% shift in profits from A to C. Note that even if the CP Exception does not apply to the 10% shift in profits from A to C, neither the Proposed Regulations, case law, nor the legislative history expressly prohibits the amendment from applying retroactively, since there is no attempt to allocate to C any items attributable to the period before it joins P and because the amended allocation is not attributable to any capital contributed by C.[97]

In the final regulations, the IRS should consider expanding the CP Exception of the Proposed Regulations to cover amendments to allocations (i) among persons that were contemporaneous partners during segments of a taxable year (even if they were not contemporaneous partners during the entire taxable year) and (ii) that involve only items allocable to such segments. That expansion would cover, among other cases, the fact pattern above, where a partner joins mid-year (x) with no contribution, or (y) with a contribution for which the contributing partner receives the same allocations with respect to its contributed capital for the period after his admission as all other partners receive for similar capital for such period.[98]

I. Coordination with Section 704

The Treasury regulations under Section 704(b) provide a safe harbor method for partnership allocations to ensure that they are respected as having "economic effect" for purposes of satisfying the substantial economic effect requirement of Section 704(b).[99] To qualify under that safe harbor, a partnership must generally maintain capital accounts in accordance with the rules of the regulations and allocate partnership items of income, gain, loss, and deduction as determined in accordance with those regulations to the capital accounts (as "book items"), rather than as tax items. A partnership's items of taxable income, gain, loss or deduction and items of book income, loss, deduction and credit can differ significantly because of (among other things) differences between the tax basis of the partnership's assets and such assets' book value as

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97 *See, e.g.*, Prop. Reg. § 1.706-4(b)(2) (allowing for the choice of "any reasonable method" to account for the varying interests of the partners in a service partnership during the taxable year, "provided that the allocations are valid under section 704(b).").

98 Note that while the 1984 Joint Committee Report specifically sanctioned the application of Section 761(c) to allocations among partners that were contemporaneous partners for the entire taxable year, the principle underlying the *Lipke* holding, that Section 761(c) does not apply to variations that are attributable to capital contributions, is consistent with applying the CP rule on a segment basis (without requiring that the beneficiaries of the rule be contemporaneous partners for the entire taxable year). *See* 1984 Joint Committee Report, *supra* note 14 (citing *Lipke v. Comm'r,* 81 T.C. 689 (1983)).

99 Treas. Reg. § 1.704-1(b).

determined for capital account purposes. A partnership following the approach of the Section 704(b) safe harbor generally will provide for the maintenance of capital accounts and the allocation of book items. Tax items will be allocated in the same manner as corresponding book items to the extent book and tax items match up, in accordance with the principles of Section 704(c),[100] with respect to gain, loss, depreciation and amortization regarding property that has a book value that differs from its adjusted tax basis.

The Section 704(b) regulations have limited cross references to Section 706. The principal cross reference is Treas. Reg. § 1.704-1(b)(1)(iii) (relating to the "effect of other sections"), which provides in part that "an allocation that is respected under Section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), and section 706(d) (and related assignment of income principles). . . ."[101]

The Proposed Regulations address the determination of a partner's distributive share of partnership items under Section 702(a) where the partner's interest in a partnership varies during a taxable year.[102] They make no reference to Section 704(b) and could be read to apply only to the allocation of tax items. Current practice in drafting partnership agreements is generally to apply Section 706 to Section 704(b) items and allocate tax items in the same manner as the corresponding book items subject to the application of Section 704(c).

We recommend that the final regulations be coordinated specifically with the Section 704(b) regulations so as to confirm that Section 706(d) applies to allocation of book items (rather than tax items). The allocation of tax items would then follow the allocation of book items in the usual manner, subject to Section 704(c) principles.

To better coordinate the Section 704(b) regulations with Section 706, certain adjustments to the Section 704(b) regulations may be desirable. For example, an adjustment to the Section 704(b) regulations might be made to take into account Section 706(d)(2) (relating to allocable cash basis items) and Section 706(d)(3) (relating to tiered partnerships), to make clear that in applying the Section 704(b) regulations the timing rules of those sections (rather than the partnership's normal method of accounting) would be used for purposes of maintaining the capital accounts.[103] Any such adjustments should be subject to the overall principle that they would not change the aggregate amounts of book items to be allocated to the partners, only the method of allocation of such amounts among the partners.[104]

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100 Section 704(c); *see also* Treas. Reg. § 1.704-1(b)(2)(iv)(f).

101 Treas. Reg. § 1.704-1(b)(2)(ii)(3) (in the context of determining when a deficit balance capital account must be restored under the test for economic effect) references Section 706(c)(2)(A) (relating to the closing of the taxable year of a partner that completely terminates its interests). Treas. Reg. § 1.704-1(b)(2)(ii)(d)(5) (defining a qualified income offset) references Section 706(d) in respect of adjustments to capital account balances for reasonably expected allocations.

102 *See* Prop. Reg. § 1.706-4(c)(1) (interim closing method); Prop. Reg. § 1.704-4(d)(1) (proration method); *see also* Prop. Reg. § 1.704-4(a)(1).

103 See, *e.g*., Treas. Reg. § 1.704-1(b)(2)(iv)(n), which requires that adjustments to capital accounts for partnership items must generally follow the federal income tax treatment of those items *at the partnership level*.

104 There may also be technical issues under the Section 704(b) regulations arising from the use of segment accounting. For example, in the context of the qualified income offset provisions of the regulations, an issue may arise in cases where, at the end of a segment, a partner has a negative capital account in excess of its deficit

J. Tiered Partnerships

Section 706(d)(3) provides that where one partnership (an "upper tier partnership") is a partner in another partnership (a "lower tier partnership") and there is a change in the interests of the partners in the upper tier partnership during the taxable year of the upper tier partnership, that "except to the extent provided in regulations" each partner's distributive share of any items of the upper tier partnership attributable to the lower tier partnership will be determined by assigning the appropriate portion (determined by applying principles similar to those in Section 706(d)(2) [relating to allocable cash basis items]) of each such item to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership and by allocating the portion assigned to any such day among the partners in proportion to their interests in the upper tier partnership at the close of such day. Thus, the daily allocation method used for cash basis items is applicable to all items of the lower tier partnership if there is a change in the interests in the upper tier partnership. No regulations or other guidance have been issued to date under Sections 706(d)(2) or (d)(3) and the Proposed Regulations do not address issues under these sections. The Preamble requests comments on the rules of Section 706(d)(3) and any other issues relating to tiered partnerships in applying Section 706(d).

Tiered partnership arrangements are very common economic arrangements and are regularly encountered in tax practice. As a result, the application of the varying interest rule of Section 706 will often involve a change in interest in an upper tier partnership that will require the application of the tiered partnership rule. Under the statute, the daily allocation method is required to be applied in respect of all items from lower tier partnerships, *except to the extent provided in regulations*. No final regulations, or even proposed regulations, have been issued. Because the application of the daily allocation rule can be administratively difficult, expensive and in some cases highly problematic,[105] taxpayers need basic guidance and relief from its burdens in appropriate circumstances.

We recommend that the final regulations include at least temporary basic guidance on tiered partnership arrangements. The guidance should confirm that an upper tier partnership that has the same taxable year as its lower tier partnership, that holds a fixed percentage interest in the lower tier partnership during a taxable year, and that uses the interim closing method, may determine the items from the lower tier partnership that are allocable to its upper tier partnership segments based on an interim closing method (as of any upper tier partnership segment end) applied to the lower tier partnership.[106] This guidance should also allow an upper tier

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restoration obligation. In this regard, see our recommendation in Section IV.D of this Report, regarding segments as separate distributive share periods. The principles of that recommendation (*i.e.*, to disregard the separate segments for certain purposes) could be extended to address such technical issues as part of the coordination of the regulations under Sections 704 and 706 at least in respect of Covered Variations that are not complete dispositions).

105 In some cases the upper tier partnership will not have, and cannot obtain, the daily allocation information from the lower tier partnership, or the cost of obtaining it would be prohibitive. This is particularly so where the upper tier partnership owns a relatively small portion (*e.g.*, 10% or less) of the lower tier.

106 This is, in effect, what we believe current law provides, adjusted for the segment concept. We understand, however, that some practitioners are concerned that Section 706(d)(3), in the above context, would require the upper tier partnership to prorate its items from the lower tier partnership over the entire year of the upper tier partnership.

partnership that has the same taxable year as its lower tier partnership, and holds a fixed percentage interest in that lower tier partnership during the upper tier partnership's taxable year, generally to prorate the items of the lower tier partnership to each day of the upper tier partnership's taxable year, subject to potential exceptions for the lower tier partnership's extraordinary items.[107] This approach should be allowed regardless of whether the upper tier partnership uses the proration method or the interim closing method with respect to its other items.[108] The regulations relating to tiered partnerships should further provide that any available conventions adopted by the upper tier partnership will be respected for purposes of applying Section 706(d)(2).

> Example 8: UTP is an upper tier partnership that owns an interest in a lower tier partnership LTP. Both UTP and LTP have calendar taxable years. UTP directly operates a business as well as owning a 25% interest in LTP. Assume UTP has no extraordinary items for 2011 and that LTP generates $400,000 of net ordinary income for 2011 (of which UTP's distributive share is $100,000). On June 30, 2011, partner A sells a 10% interest in UTP to B. Under the approach described above, UTP's $100,000 of ordinary income from LTP would be prorated equally to each day and allocated to the partners of UTP in accordance with their varying interests in UTP.[109] The remaining items of UTP (*e.g.*, items derived from its directly conducted business) would be allocated using either the interim closing method or the calendar day method, depending on the method elected by UTP.

Any conventions applicable to the upper tier partnership should generally also apply to income derived from a lower tier partnership for purposes of applying Section 706(d)(3).[110] A rule regarding the application of conventions in tiered partnership arrangements should be provided regardless of whether the proration approach described above is adopted.

> Example 9: Same facts as Example 8, except that UTP adopts the semi-monthly convention for 2011 and A sells its interest to B on June 17, 2011. A should be treated for all purposes of applying Section 706, including the application of

[107] Appropriate modifications to this rule, consistent with the Section 706 approach for single tier partnerships, would apply where the upper tier partnership's interest in the lower tier partnership varies during the taxable year. Consideration should also be given to whether our recommendations regarding tiered partnerships should be extended to cases where the upper tier partnership and its lower tier partnership have different taxable years. We have not fully analyzed that issued. Our recommendations are limited to cases where the taxable years are the same in order to present a fact pattern that covers the majority of cases and which we hope can be promptly addressed in the final regulations or in other guidance.

[108] Note that restrictions under Section 706(b) on the taxable years that partnerships may adopt have had the practical effect of reducing substantially the number of cases where the upper tier partnership and the lower tier partnership have different taxable years. The proposal set forth would accordingly provide helpful guidance for most tiered partnership arrangements.

[109] Thus, A would be allocated approximately $5,000 of the income from LTP (100,000 x 10% x 182/365).

[110] Note the statement from the 1984 Joint Committee Report: "[e]ffectively under this rule, the existence of the tiered partnership arrangement is ignored for allocation purposes and items of the lower tier partnership 'flow through' to the partners in the upper tier partnership in accordance with their effective interests in the lower tier partnership as of the close of each day." 1984 Joint Committee Report, *supra* note 14 at 221.

Section 706(d)(3), as though it had sold its interest to B at the close of business on June 15, 2011.

K. Cash Basis Items

The Preamble requests comments as to whether the list of allocable cash basis items in Section 706(d)(2) should be expanded to include other items (*e.g.*, property insurance), as well as other comments regarding the cash basis items provision. In this regard, we have two observations. First, it is unclear whether Section 706(d)(3) applies only to allocable cash basis items that are deduction items, or whether it also applies to allocable cash basis income items. This should be clarified by regulation. Second, we note that the ability of partnerships to effect retroactive allocations through the use of the cash method have been substantially reduced since the 1984 Act and, accordingly, the importance of these provisions as an anti-avoidance tool have been substantially diminished. Relevant developments include the adoption of the original issue discount rules, limitations under Section 448 on partnerships that are eligible to use the cash method and enhanced rules regarding capitalization of expenses.

L. Comments on Service Partnerships

The Proposed Regulations define a service partnership as a partnership in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, and provide more flexible Section 706(d) rules for such partnerships. One question is the scope of the definition of consulting. For example, would investment advisory or management services be covered within the scope of consulting? More generally, query why some categories of services are covered by this rule and others are not.[111] That is, why is the type of service a controlling factor, rather than focusing on whether substantially all of the activities and/or income of the partnership is attributable to the performance of services?[112] If the final regulations adopt the approach of applying the safe harbor only to specified services, consideration should be given to providing in the final regulations the ability for the IRS to expand this list by revenue ruling, or other administrative guidance (such as a notice).

The safe harbor for service partnerships provides that a partnership and partner may choose any reasonable method to account for a variation in the partner's interest in the partnership. The rule implicitly appears to sanction the use by the partnership of multiple methods during the year. If our recommendation to allow a partnership to use multiple methods and conventions is not adopted, the final regulations should clarify that the general restriction on use of multiple methods and conventions does not apply to service partnerships.

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[111] It would appear, for example, that property management services would not be covered, nor would the function of serving as a general partner of a real estate or investment fund.

[112] Note Section 736(b), which distinguishes treatment based on whether capital is a material income-producing factor for the partnership.