March 12, 2010

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Under Section 706

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations under Section 706. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis
Chair, Section of Taxation

Enclosure

cc: Michael Mundaca, Acting Assistant Secretary (Tax Policy), Department of the Treasury
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ABA SECTION OF TAXATION
COMMENTS ON
PROPOSED REGULATIONS UNDER SECTION 706

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jennifer Alexander, Michael Scaramella, and Svet Minkov of the Partnerships and LLCs Committee of the Section of Taxation. Substantive contributions were made by Eric Sloan, Bill O’Shea, Matthew Lay, Russell Stein, Karen Hughes, Paul Carman, and Monte Jackel. The Comments were reviewed by Todd Golub, Vice-Chair of the Partnerships and LLCs Committee, and Susan Mello, Chair of the Partnerships and LLCs Committee. The Comments were further reviewed by Richard M. Lipton of the Section’s Committee on Government Submissions and by William Caudill, Council Director for the Partnerships and LLC’s Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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March 12, 2010
EXECUTIVE SUMMARY

Section 706 provides guidance regarding the required taxable year of a partnership and the taxable year of a partner in which the income, gain, loss, deduction, and credit of a partnership is includable in computing the partner’s taxable income.

Congress has granted significant discretion to the Secretary of the Treasury Department (the “Secretary”) in administering and defining the scope of section 706 through Regulations. The Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) have exercised this discretion principally through the issuance of Regulation section 1.706-1, which was published in final form in the Federal Register on May 25, 1956. Since the publication of the existing Regulations, Congress has amended the Code several times both to clarify and to change substantively the provisions of section 706. The existing Regulations under section 706, however, do not reflect all of these amendments.

On April 14, 2009, the Treasury and the Service issued a notice of proposed rulemaking in the Federal Register containing Proposed Regulations under section 706 (the “Proposed Regulations”). The Proposed Regulations would conform the Regulations to changes Congress has made to section 706. The Proposed Regulations also would amend the rules for determining the required taxable year of partnerships with “disregarded foreign partners.” More broadly, and more pertinent to the comments contained in this submission, however, the Proposed Regulations would amend the rules regarding the determination of partners’ distributive shares of partnership items when a partner’s interest varies during a partnership’s taxable year (the “Varying Interest Rule”).

Very generally, the Proposed Regulations retain the interim closing of the books and the proration methods as the available methods under the Varying Interest Rule. The Proposed Regulations clarify the application of these methods, however, by adopting the term “segment” to describe the various periods during the partnership’s taxable year for which the partnership must account for variations in partners’ interests. Thus,

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1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
2 See, e.g., I.R.C. § 706(b)(1)(B)(iii) (providing that if there is no taxable year described under I.R.C. § 706(b)(1)(B)(i) or (ii), the calendar year must be used, unless the Secretary by Regulations prescribes another period); I.R.C. § 706(d)(1) (giving the Secretary the authority to prescribe the methods by which partners must take into account their varying interests in the partnership during any taxable year of the partnership in which there is a change in any partner’s interest); I.R.C. § 706(d)(2)(B)(iv) (providing that, by Regulation, the Secretary may require a partnership to treat any item for which a partnership uses the cash receipts and disbursements method of accounting as an “allocable cash basis item”).
5 Prop. Reg. § 1.706-1(b)(6)(i).
7 Id.
8 Prop. Reg. § 1.706-4(a)(2).
“segments” simply refers to specific periods of the partnership’s taxable year that are determined under one of three conventions: (i) the calendar day convention, (ii) the semi-monthly convention, and (iii) the monthly convention. The Proposed Regulations also change the proration method by providing a list of items that the partnership cannot prorate, but, rather, must account for on an interim closing of the books method.\(^9\)

We commend the Treasury and the Service for clarifying the application of the Varying Interest Rule and for conforming the existing Regulations to the Code. Further, we appreciate the opportunity to provide comments on these changes and other issues arising under the Proposed Regulations.

Specifically, we recommend that the final Regulations:

1. With respect to the proration method:
   
   a. Retain the flexibility of the existing Regulations by allowing a partnership to use any proration method that is reasonable to determine its partners’ distributive shares of partnership items for any partnership taxable year in which a partner’s interest varies;
   
   b. Expand the service partnership safe harbor to certain non-service partnerships if the Treasury and the Service do not adopt the immediately preceding recommendation to allow partnerships to use any proration method that is reasonable;
   
   c. Permit extraordinary items to be allocated under either the calendar day convention or the semi-monthly convention;
   
   d. Clarify that adjustments resulting from a revaluation of partnership property pursuant to Regulation section 1.704-1(b)(2)(iv)(e) or (f) are extraordinary items;
   
   e. Clarify that gains or losses from the actual or deemed sale of securities by securities partnerships engaged in the trade or business of trading securities are not extraordinary items;

2. Expand the scope of the monthly convention safe harbor to allow all partnerships, rather than just publicly traded partnerships (“PTPs”), to use a monthly convention under certain circumstances;

3. Specify what constitutes an “agreement of the partners” that permits a partnership and its partners to use the proration method;

4. Allow different methods and conventions to be used to account for different variations in partners’ interests that occur in the same partnership

\(^9\) Prop. Reg. § 1.706-4(d).
taxable year, provided that the various methods and the combination of
methods are reasonable under the circumstances;

5. Provide examples clarifying when retroactive allocations are attributable
to capital contributions to and distributions from a partnership and confirm
that retroactive allocations may be made among partners who are members
of the partnership for an entire segment; and

6. Clarify the proper accounting for items under the interim closing method
that either (i) are not determined until the end of the taxable year and do
not relate to any discrete event that occurred during the taxable year or
(ii) require an analysis of, or are conditioned on, the results for the entire
taxable year.

In addition to our recommendations, we also provide our general observations
regarding the determination of a partner’s distributive share of cash basis items under
section 706(d)(2) and items attributable to interests in lower-tier partnerships under
section 706(d)(3).
STATUTORY AND ADMINISTRATIVE BACKGROUND

I. Section 706 and the Existing Regulations

A. General Guidance Provided by Section 706

In computing its taxable income for a taxable year, a partner must include the partner’s distributive share of the partnership’s income, gain, loss, deduction, and credit (collectively, the “partnership items”) for any partnership taxable year ending with or within the partner’s taxable year.10

Except in the case of a termination governed by section 708(b), and except as provided in section 706(c)(2)(A), the taxable year of a partnership does not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner’s interest in the partnership, or the sale or exchange of a partner’s interest in the partnership.11 Section 706(c)(2)(A) provides that the taxable year of a partnership does close with respect to a partner whose entire interest terminates whether by reason of death, liquidation, or otherwise. Section 706(c)(2)(B) confirms the limited scope of section 706(c)(2)(A) by explicitly providing that the taxable year of a partnership does not close with respect to a partner at the time the partner sells or exchanges less than its entire interest in the partnership or with respect to a partner whose interest is reduced whether by entry of a new partner, partial liquidation of the partner’s interest, gift, or otherwise. Regardless of whether the partnership’s taxable year closes, section 706(d)(1) provides that the partnership must determine each partner’s distributive share of partnership items in accordance with the Varying Interest Rule if there is a change in any partner’s interest in the partnership during the partnership’s taxable year.12

Sections 706(d)(2) and (3) provide special rules under the Varying Interest Rule with respect to the treatment of “allocable cash basis items” and the allocation of partnership items when a partner’s interest changes in a partnership that is a partner in another partnership.

B. The Varying Interest Rule

Regulation section 1.706-1(c)(2)(ii) prescribes two general methods to determine the distributive share of partnership items for a partner that sells, exchanges, or liquidates its entire interest in a partnership.13 Those methods are the interim closing of the books method (the “interim closing method”) and the proration method. The proration method may be used only “by agreement among the partners,” making the interim closing method the default method.14

10 I.R.C. § 706(a); Reg. § 1.706-1(a)(1).
11 I.R.C. § 706(c)(1).
12 I.R.C. § 706(d)(1).
13 The existing Regulations do not reflect a 1984 amendment to section 706 clarifying that the Varying Interest Rule applies equally to complete and partial dispositions of a partner’s interest in a partnership. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 72, 98 Stat. 494.
14 Reg. § 1.706-1(c)(2)(ii).
Under the interim closing method, a partnership determines its partners’ distributive shares of partnership items by closing its books and allocating the resulting partnership items among the partners in accordance with their respective interests as of the interim closing.\textsuperscript{15} Two “conventions” are available under the interim closing method to establish when a partnership must determine its partners’ distributive shares of partnership items (\textit{i.e.}, when a partnership must close its books): a daily convention and a semi-monthly convention.\textsuperscript{16} The daily convention requires the partnership to determine the partners’ distributive shares of partnership items on the calendar day that the sale, exchange, liquidation, or other event occurs. The semi-monthly convention requires the partnership to determine its partners’ distributive shares of partnership items by treating a partner entering during the first 15 days of the month as entering on the first day of the month and by treating a partner entering after the 15th, but on or before the last, day of the month as entering on the 16th day of the month.\textsuperscript{17} Thus, under the semi-monthly convention, a partnership will have to close its books as a result of changes in partners’ interests not more than twice in any month.

Under the proration method, the partnership may determine its partners’ distributive shares of partnership items by allocating to the partners a pro rata portion of the partnership items for that taxable year.\textsuperscript{18} The existing Regulations provide two methods for prorating partnership items: (i) the proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation or (ii) the proration may be determined under any other method that is reasonable.\textsuperscript{19} The existing Regulations do not elaborate on how to determine if a proration method is reasonable.

\textbf{II. The Proposed Regulations}

As discussed in detail below, the focus of the Proposed Regulations is on prescribing and clarifying the methods and conventions that a partnership and its partners may use under the Varying Interest Rule. The Proposed Regulations, however, also include several other notable changes that are not discussed in these Comments. Section II.B. lists these changes.

\textsuperscript{15} \textit{Id.}
\textsuperscript{16} IR-News Rel. 84-129, IR 84-129, 1985 PH ¶54,613.
\textsuperscript{17} \textit{Id.}
\textsuperscript{18} Reg. § 1.706-1(c)(2)(ii).
\textsuperscript{19} \textit{Id.; see also} Rev. Rul. 77-310, 1977-2 C.B. 217 (providing an example of an acceptable method of allocating losses sustained in substantially equal amounts each month among the partners when their profit and loss sharing percentages were changed substantially one month before the end of the taxable year as a result of capital contributions from several existing partners; issued under section 706(c)(2)(B) as in effect before the Deficit Reduction Act of 1984); Rev. Rul. 77-311, 1977-2 C.B. 218 (providing an example of an acceptable method of allocating a distributive share of losses from a lower-tier partnership to the partners of an upper-tier partnership when those partners’ profit and loss sharing percentages were substantially changed one month before the end of the taxable year as the result of a capital contribution from a new partner; issued under section 706(c)(2)(B) as in effect before the Deficit Reduction Act of 1984).
A. **The Varying Interest Rule**

1. **In General**

Consistent with the existing Regulations, the Proposed Regulations generally allow a partnership to use either the interim closing or proration method in determining its partners’ distributive shares of partnership items when a partner’s interest in the partnership varies during the partnership’s taxable year. In addition, the interim closing method remains the default method under the Proposed Regulations.

The Proposed Regulations retain the two conventions available under existing law and their general applicability to each method. Thus, a partnership using the interim closing method may use either the calendar day convention (referred to as the daily convention under existing law) or the semi-monthly convention to determine the days on which each period starts and ends. A partnership using the proration method may use only the calendar day convention. The Proposed Regulations refer to these specific periods of the partnership’s taxable year as “segments.” Once a partnership has selected a method and convention to apply the Varying Interest Rule, Proposed Regulation section 1.706-4(a)(1) requires the partnership and all of its partners to use the same method and convention for all variations in the partners’ interests during that taxable year.

The Proposed Regulations provide two safe harbors that allow certain partnerships to deviate from the prescribed methods and conventions under the Varying Interest Rule. The first safe harbor allows a service partnership to determine a partner’s share of partnership items under the Varying Interest Rule by using any reasonable method, provided that the allocations are valid under section 704(b). The second safe harbor allows PTPs to use a monthly convention.

2. **The Proration Method**

As stated above, the Proposed Regulations retain the proration method. In prorating the partnership items among the segments for the taxable year, a partnership first aggregates the partnership items (other than the extraordinary items as described below) for the taxable year and treats the aggregate of those items as a single partnership item for purposes of allocating the aggregated items among the various segments.

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21 Prop. Reg. § 1.706-4(c)(2).
23 Prop. Reg. § 1.706-4(b)(2). The Proposed Regulations define a service partnership as a partnership for which substantially all of the activities involve the performance of services in the areas of health, law, engineering, architecture, accounting, actuarial science or consulting.
25 Prop. Reg. § 1.706-4(d)(1). At an American Bar Association panel discussion on the Proposed Regulations held on May 8, 2009, in Washington, D.C., a representative from the Service asserted that, under the Proposed Regulations, a partnership and its partners would not be permitted to use the proration method for a partnership taxable year that contains an extraordinary item. We believe that neither the
Next, the partnership allocates the aggregated partnership item proportionately among the various segments based on the number of days in each segment. Finally, the partnership determines the partners’ distributive shares of the partnership items for the taxable year by taking into account the partners’ interests in the items allocated to each segment. The following example from the Proposed Regulations demonstrates the application of the proration method.

PRS is a partnership that was formed in 2004. It has three partners, P, R, and S, who each own a one-third interest in the partnership. PRS owns and operates a skiing enterprise, and under section 706(b)(1)(C), has adopted a calendar year end of June 30th. Each partner is an individual who is on the calendar year. On December 31, 2010, S sold her entire interest in PRS to Y. PRS, for its fiscal year ending June 30, 2011, earned $150,000 of income. The partnership has a specific provision in the partnership agreement agreeing to use the proration method when accounting for varying interests in the partnership. (See § 1.706–4(a)(1)). Using the proration method, $75,000 of income is included in the first segment of the year that begins July 1, 2010 and ends December 31, 2010, and $75,000 is included in the second segment of the year that begins January 1, 2011 and ends June 30, 2011. For the first segment, S’s distributive share of partnership income is one-third of $75,000, or $25,000. For the second segment, Y’s distributive share of partnership income is one-third of $75,000, or $25,000. Because S sold her entire interest in PRS, the partnership taxable year closes with respect to her pursuant to § 1.706–1(c)(2)(i). Thus, she must include her distributive share of PRS’s income, or $25,000, on her 2010 Federal income tax return.27

Under the proration method of the Proposed Regulations, certain “extraordinary items” are excluded from the general aggregation approach.28 Instead, Proposed Regulation section 1.706–4(d)(3) provides that a partnership must allocate such extraordinary items among the partners in proportion to their interests at the beginning of the calendar day on which the extraordinary items are taken into account. Proposed Regulation section 1.706–4(d)(3) defines an extraordinary item to include any of the following: (i) the disposition or abandonment of a capital asset (other than in the ordinary course of business); (ii) the disposition or abandonment of section 1231 property (other than in the ordinary course of business); (iii) the disposition or abandonment of a section 1221(a)(1), (3), (4) or (5) asset if substantially all of 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); (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; (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; or (ix) any item that,

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26 We believe that the example should read that PRS selected a fiscal or taxable year end of June 30th and not a calendar year end of June 30th.
in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income.

B. **Other Changes Made by the Proposed Regulations**

The following list summarizes the other material changes that the Proposed Regulations make to the existing Regulations and other material issues addressed in the Proposed Regulations:

1. The Varying Interest Rule does not apply to changes in the allocations among partners who were members of the partnership for the entire taxable year of the partnership provided that the changes are not attributable to a capital contribution to or distribution from the partnership and that the changes satisfy the requirements of section 704(b);29

2. The Varying Interest Rule applies to the disposition of less than a partner’s entire interest in the partnership;30

3. The taxable year of the partnership closes with respect to a partner whose entire interest in a partnership terminates by reason of death;31

4. The rules regarding when to consider foreign partners’ interests in determining a partnership’s taxable year;32 and

5. When a deemed disposition of a partner’s entire interest under other sections of the Regulations is a deemed disposition of a partner’s entire interest for purposes of section 706(d).33

**PROPOSALS AND ANALYSIS**

I. **Specific Recommendations to the Proration Method**

A. **Retain the Flexibility of the Existing Regulations by Allowing Partnerships to Use Any Proration Method That Is Reasonable**

The existing Regulations under section 706 provide partnerships with considerable discretion regarding how to determine partners’ distributive shares of partnership items under the proration method. Specifically, Regulation section 1.706-1(c)(2)(ii) provides, in pertinent part, that if, by agreement among the partners, the partnership uses the proration method, the partnership may determine the proration of partnership items either (i) based on the portion of the taxable year that has elapsed prior to the disposition or (ii) under any other method that is reasonable. This discretion

31 Prop. Reg. § 1.706-1(c)(2).
33 Prop. Reg. § 1.706-1(c)(2)(iii).
provides partnerships with a flexible framework within which to determine partners’
distributive shares under the proration method without imposing undue administrative
borders on the partnerships or creating significant inequities among their partners.

Partnerships using the proration method under the existing Regulations may use a
hybrid approach that is analogous to the proration method prescribed by the Proposed
Regulations. Under this hybrid approach, a partnership separates certain extraordinary
items and allocates them to the partners based on their interests in the partnership on
particular days or periods (e.g., the date a significant asset is sold), effectively using the
interim closing method with respect to these extraordinary items. The partnership then
allocates the remaining partnership items based on the partners’ pro rata shares of those
items for the entire taxable year.

Although similar in principle, the proration methods under the existing
Regulations and the Proposed Regulations differ with respect to the extent to which they
allow a partnership to determine whether an item should be accounted for as an
extraordinary item. The existing Regulations require only that the proration method be
reasonable, giving partnerships considerable discretion in deciding which items, if any,
should be accounted for as extraordinary items. The Proposed Regulations, conversely,
provide a predetermined list of extraordinary items and apparently allow no discretion to
partnerships in deciding whether those items should be treated as extraordinary items
under a partnership’s particular facts, and perhaps more significantly, whether items not
included in the list should be treated as extraordinary items.

While we commend the Treasury and the Service for confirming that the hybrid
approach used by taxpayers is appropriate under section 706, we recommend the final
Regulations provide more flexibility with respect to determining what items may be
treated as extraordinary. While there are circumstances in which separate accounting
may be the more appropriate treatment for the items listed in the Proposed Regulations,
requiring partnerships to account for these items separately under every circumstance is
likely to impose significant administrative burdens and costs on partnerships and may
result in allocations that distort the economic deal the partners negotiated. For example,
under the Proposed Regulations, a partnership would be required to account for the
settlement of a tort as an extraordinary item regardless of what portion of the
partnership’s gross expenses the settlement represents. Consequently, a partnership

34 See Reg. § 1.706-1(c)(2)(ii) (allowing a partnership to adopt any proration method as long as that
method is reasonable).
35 See Prop. Reg. § 1.706-4(d)(3) (providing that a partnership must allocate extraordinary items, as
defined by that paragraph, in proportion to the partners’ interests at the beginning of the calendar day on
which they are taken into account).
36 As mentioned above, at an American Bar Association panel discussion on the Proposed
Regulations, a representative from the Service asserted that, under the Proposed Regulations, a partnership
and its partners would not be permitted to use the proration method for a partnership taxable year that
contains an extraordinary item. While we believe that neither the Proposed Regulations nor their preamble
supports this interpretation, we believe that the final Regulations should clarify that a partnership and its
partners may use the proration method for a partnership taxable year that contains an extraordinary item.
37 See Prop. Reg. § 1.706-4(d)(3)(vii) (defining any item from the settlement of a tort or similar
third-party liability or payment of a judgment as an extraordinary item).
that settles a tort for $1 would be required to account for the settlement separate from its other items for the taxable year and determine its partners’ interests in the settlement at the beginning of the calendar day on which the settlement is taken into account. Likewise, because, for example, the Proposed Regulations do not define depreciation as an extraordinary item, a partnership that places a significant asset in service during the taxable year would not be able to account for depreciation from that asset separately under the proration method. In this case, if the economic deal was that only partners who are members of the partnership at the time that depreciable assets are placed in service receive a distributive share of the resulting depreciation expense, the partnership’s inability to account for the depreciation expense separately would result in allocations that distort the economic deal the partners negotiated.

While the Proposed Regulations bring some amount of certainty to the law, they do so at the expense of the flexibility that the existing Regulations have historically allowed to partnerships. We are unaware of any abuse, perceived or actual, that warrants limiting a partnership’s discretion to determine whether an item should be treated as extraordinary under its particular circumstances. Moreover, a reasonableness requirement, like the one under the existing Regulations, adequately addresses any concerns of potential abuse.

While certainty may bring simplicity, rules that provide certainty may not be flexible enough to govern the diverse range of businesses and transactions in which partnerships engage, and the even more diverse group of taxpayers who are partners in those partnerships. Therefore, we believe that the principles of section 706 are best administered through Regulations that provide partnerships with a reasonable amount of discretion in determining how to apply the Varying Interest Rule instead of hard and fast rules that dictate the only available methods and conventions. We further believe that, in the absence of abuse, the benefits to taxpayers of flexibility should outweigh the additional certainty of result that the Treasury and the Service are seeking to provide in this area.

Accordingly, we recommend that the final Regulations retain the flexibility of the existing Regulations by allowing partnerships to use any reasonable proration method to determine partners’ distributive shares of partnership items under the Varying Interest Rule and that the final Regulations provide examples of, and general guidelines for determining, “reasonable” proration methods. We recommend that the final Regulations generally provide that the treatment of an item under a proration method will not be reasonable if a principal purpose in selecting the treatment of a particular item is to reduce the present value of the partners’ aggregate tax liability. 38 We believe this approach safeguards against any perceived abuses without reducing the overall flexibility

38 Cf. Reg. § 1.704-3(a)(10) (providing that an allocation method under section 704(c) is not reasonable if the contribution of property (or an event that results in a reverse section 704(c) item) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability).
that may be needed in administering the Varying Interest Rule to allow partnerships to respond to the diverse circumstances encountered in their operations.

We also recommend that the final Regulations provide a safe harbor under which a proration method is deemed to be reasonable for those extraordinary items listed in the Proposed Regulations that are less than a *de minimis* amount of the partnership’s items for the taxable year. We recommend that an extraordinary item (as defined by the final Regulations) be considered *de minimis* if, for the partnership’s taxable year (i) the total of the particular class of extraordinary items (e.g., all tort liabilities) is less than five percent of the partnership’s (a) gross income in the case of income or gain items or (b) gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items and (ii) all extraordinary items (as defined by the final Regulations) in total do not exceed $10 million (collectively, the “*De Minimis* Rule”). This approach should have the benefit of reducing the administrative burden placed on both partnerships and the Service as a result of extraordinary items.

The following examples demonstrate the application of our recommendations with respect to the proration method. For each example, unless otherwise noted: (i) PRS is a partnership for federal income tax purposes; (ii) PRS has at all times three equal partners, P, R, and S, each of which is subject to federal income tax on its taxable income at the highest marginal rate; (iii) PRS is engaged in an active trade or business and has a calendar taxable year; (iv) PRS’s partnership agreement contains a provision that allows P, the general partner of PRS, to select the section 706 method and to make any related decisions when accounting for varying interests in the partnership; (v) the allocations satisfy the requirements of section 704(b); and (vi) the final Regulations adopt the list of extraordinary items set forth under Proposed Regulation section 1.706-4(d)(3).

Example 1 concludes that a proration method is deemed to be reasonable when the partnership prorates an extraordinary expense that is less than five percent of the partnership’s gross expenses and losses and the total of the partnership’s extraordinary items for its taxable year does not exceed $10 million.

**Example 1 – *De Minimis* Rule Satisfied.** On July 1, S sells its entire interest in PRS to Y. For its taxable year, PRS has gross income from its operations of $20 million and gross expenses of $15 million. PRS’s gross expenses include, among other items, one extraordinary item, a $250,000 tort settlement that PRS paid on June 1. PRS has no other extraordinary items. P decides to use a proration method under which all items will be prorated over the entire taxable year, including the tort settlement.

PRS’s proration method is deemed to be reasonable under the *De Minimis* Rule because the $250,000 tort settlement represents less than five percent of PRS’s gross expenses and losses (i.e., $750,000) and the total of PRS’s extraordinary items for its taxable year does not exceed $10 million.
Example 2 concludes that a proration method is not deemed to be reasonable under the *De Minimis* Rule when the partnership prorates an extraordinary expense that is less than five percent of the partnership’s gross expenses and losses but exceeds $10 million. The example also provides, however, that the proration method may still be reasonable if the partnership demonstrates that a principal purpose of the proration method was not the reduction of the partners’ aggregate tax liability.

**Example 2 – *De Minimis* Rule Not Satisfied.** On July 1, S sells its entire interest in PRS to Y. For its taxable year, PRS has gross income from its operations of $500 million and gross expenses of $450 million. PRS’s gross expenses include, among other items, one extraordinary item under the final Regulations, a $20 million tort settlement paid on June 1. PRS has no other extraordinary items. P decides to use a proration method under which all items will be prorated over the entire taxable year.

Although the tort settlement is less than five percent of PRS’s gross expenses (*i.e.*, $22.5 million), it exceeds the $10 million ceiling of the *De Minimis* Rule. Thus, the proration method is not deemed to be reasonable under the *De Minimis* Rule. The proration method adopted, however, may still be reasonable if the partnership demonstrates that a principal purpose of the proration method was not the reduction of the partners’ aggregate tax liability.

In Example 3 a partnership treats as an extraordinary item an item of expense that is not listed under the Proposed Regulations as an extraordinary item. The example concludes that the proration method may be reasonable if the partnership demonstrates that a principal purpose of the proration method was not the reduction of the partners’ aggregate tax liability.

**Example 3 – Additional Extraordinary Item.** The facts are the same as in Example 1, except that PRS’s gross expenses include, among other items, $750,000 of depreciation expense from an office building that PRS placed into service on August 1. P decides to use a proration method under which all items will be prorated over the entire taxable year except for the $750,000 of depreciation expense related to the office building. Under P’s proration method, the $750,000 of depreciation expense will be allocated to the partners who were members of PRS on August 1 based on their proportionate interest in the partnership for the months including, and following, the month in which PRS placed the building into service.

The general rule allowing partnerships to use any reasonable proration method allows PRS to separately account for the $750,000 of depreciation expense provided that the approach used
by PRS is reasonable. Provided PRS demonstrates that a principal purpose of the proration method adopted is not the reduction of the partners’ aggregate tax liability, PRS may account separately for a significant, discrete event (i.e., placing the office building in service) that the final Regulations do not list as an extraordinary item. The proration of the remaining partnership items is deemed reasonable as a result of meeting the De Minimis Rule (as discussed in the explanation to Example 1).

B. Alternative Recommendation: Expand the Service Partnership Safe Harbor to Allow Certain Partnerships to Use Any Proration Method That Is Reasonable

Alternatively, if the Treasury and the Service do not adopt our first set of recommendations, we recommend that the final Regulations extend the service partnership safe harbor to certain partnerships that satisfy specific revenue and allocation thresholds. Under this approach, if a partnership’s gross receipts for a taxable year are $100 million or less and if no partner receives an allocation of an item listed under section 702(a) in excess of $10 million, then the partnership would be allowed to use any reasonable method or convention to account for varying interests. We believe this extension would provide relief to a significant number of partnerships that otherwise would incur considerable costs and administrative burdens when applying the rules of the Proposed Regulations.

C. Permit Extraordinary Items to Be Allocated Under Either the Calendar Day Convention or the Semi-Monthly Convention

The methods available under the Proposed Regulations to account for variations in partners’ interests (i.e., the interim closing and proration methods) do not provide partnerships and their partners with equal flexibility in accounting for extraordinary items. Under the proration method, extraordinary items are accounted for as of the day that they are taken into account; whereas, under the interim closing method, extraordinary items are accounted for under either the calendar day or semi-monthly convention. So, under the interim closing method, but not under the proration method, taxpayers may choose to account for extraordinary items under the semi-monthly convention. A simple example demonstrates the effect of this disparity. Assume a partner sells an interest in a partnership on July 5. Assume further that the partnership pays a tort settlement on July 2. Under the proration method, a portion of the tort settlement must be allocated to the transferor partner because the Proposed Regulations require the tort settlement to be accounted for under the calendar day convention (i.e., based on the partners’ interests in the partnership on July 2). For a partnership using the interim closing method, adopting the semi-monthly convention, however, the transferor partner is not allocated any portion

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39 Cf. Reg. § 1.199-4(e) (providing, in part, that a taxpayer that has average annual gross receipts for the three taxable years preceding the current taxable year of $ 100 million or less may use a simplified method to apportion deductions between domestic production gross receipts and non-domestic production gross receipts).
of the tort settlement despite being a partner in the partnership on the day that the debt was discharged. (Under the semi-monthly convention, a partner than enters the partnership during the first 15 days of the month is treated as entering on the first day of the month.)

We recommend that the final Regulations provide that partnerships using the proration method may allocate extraordinary items among their partners under either the calendar day convention or the semi-monthly convention. This change will provide partnerships and their partners with the same flexibility with respect to extraordinary items whether the proration method or the interim closing method is adopted.

D. Clarify that Adjustments Resulting from a Revaluation of Partnership Property Pursuant to Regulation Section 1.704-1(b)(2)(iv)(e) or (f) are Extraordinary Items

We recommend that the final Regulations clarify that adjustments to reflect how unrealized gains or losses would be allocated to partners’ capital accounts pursuant to a revaluation of partnership property under Regulation section 1.704-1(b)(2)(iv)(e) or (f) are extraordinary items. Regulation section 1.704-1(b)(2)(iv)(f) provides that a partnership agreement may, upon the occurrence of certain events, adjust the capital accounts of the partners to reflect a revaluation of partnership property. The permissible revaluation events often result in a variation in the partners’ interests in the partnership. Consequently, adjustments to partners’ capital accounts made under these provisions often occur in partnership taxable years in which the Varying Interest Rule also applies.

While the adjustments to the partners’ capital accounts made pursuant to these revaluation provisions reflect the manner in which the unrealized appreciation or depreciation inherent in the revalued property would be allocated among the partners if the property were sold in a taxable disposition, it is not clear under the Proposed Regulations whether these adjustments would be treated as resulting from the “disposition” of the revalued property for purposes of determining if the adjustments are extraordinary items. We recommend that the final Regulations clarify this point and provide that adjustments to partners’ capital accounts made pursuant to these revaluation provisions are treated as adjustments resulting from the disposition of the partnership property for purposes of determining whether the adjustments are extraordinary items.

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E.g., Reg. § 1.704-1(b)(2)(iv)(f)(5)(i) (permitting the revaluation of partnership property upon the contribution of money or other property to the partnership by a new or existing partner as consideration for an interest in the partnership); Reg. § 1.704-1(b)(2)(iv)(f)(5)(ii) (permitting the revaluation of partnership property upon the distribution of money or other property by the partnership to a partner as consideration for an interest in the partnership); Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii) (permitting the revaluation of partnership property upon the grant of an interest in the partnership on or after May 6, 2004, as consideration for the provision of services to the partnership).


For similar reasons, we believe partnership or partner minimum gain under Reg. § 1.704-2 also should be treated as an extraordinary item.
E. **Clarify that Gains or Losses from the Sale of Securities by a Securities Partnerships Engaged in the Trade or Business of Trading Securities are Not Extraordinary Items**

In general, securities partnerships, as defined in Regulation section 1.704-3(e)(3)(iii), engaged in the trade or business of trading securities frequently buy and sell securities. If a securities partnership had to account for each sale of a security as an extraordinary item, the securities partnership would incur significant administrative and accounting costs. We recommend that the final Regulations clarify that gains or losses from the actual or deemed sale of securities by securities partnerships engaged in the trade or business of trading securities are items resulting from the disposition of a capital asset in the ordinary course of the partnership’s business and thus are not extraordinary items.43

II. **Expanding the Scope of the Monthly Convention Safe Harbor**

Under both the existing Regulations and the Proposed Regulations, partnerships may apply the Varying Interest Rule using either the interim closing or proration method.44 Before applying either of these methods, however, a partnership must first determine how to divide its taxable year into the periods to which the partnership will allocate the partnership items. A partnership determines these periods, referred to under the Proposed Regulations as “segments,”45 based on a set of rules, or “conventions,” that govern when the events that cause a partner’s interest to vary are treated as occurring for purposes of the Varying Interest Rule.

The Proposed Regulations generally preserve the conventions available under existing law by permitting a partnership using the interim closing method to use either a semi-monthly or calendar day convention and by permitting a partnership using the proration method to use only the calendar day convention.46 Under the Proposed Regulations, the semi-monthly convention allows a partnership to treat certain transactions that cause partnership interests to vary as occurring on the last day of the immediately preceding month if the transaction occurred during the first 15 days of the month or as occurring on the 15th day of the month.47 The calendar day convention, as its name

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43 If Treasury and the Service adopt this recommendation, for similar reasons, we also suggest that Treasury and the Service consider extending the rule to gains or losses with respect to property accounted for under mark-to-market regimes (e.g., section 1256 contracts, which generally are required to be treated as sold for fair market value on the last business day of the taxable year).
44 Reg. § 1.706-1(c)(2)(ii); Prop. Reg. § 1.706-4(a)(1).
45 See Prop. Reg. § 1.706-4(e).
46 See Prop. Reg. § 1.706-4(e). Rev. Proc. 2003-84, 2003-2 C.B. 1159, permits partnerships that invest in tax-exempt bonds to elect to enable partners to take into account monthly inclusions required under sections 702 and 707(c) by means of monthly closings. We assume the rules under the Proposed Regulations do not affect the election available under Rev. Proc. 2003-84, but recommend that the final Regulations confirm that the final Regulations do not affect the election available under Rev. Proc. 2003-84.
47 Prop. Reg. § 1.706-4(e)(2).
suggests, requires a partnership to account for the transaction on the day that the variation occurs (e.g., the sale date). 48

The Proposed Regulations also provide two safe harbors that allow certain partnerships to deviate from the semi-monthly and calendar day conventions. 49 The first safe harbor permits a service partnership to use any reasonable method or convention to account for varying interests of its partners as long as the allocations are valid under section 704(b). 50 The second safe harbor allows a PTP to apply a monthly convention under either the interim closing or proration methods by treating certain transfers during a calendar month as occurring on the first day of the following month for purposes of section 706. 51

We applaud and support the actions of Treasury and the Service to provide greater flexibility under the Proposed Regulations with respect to the conventions that service partnerships and PTPs may use. We recommend, however, that the final Regulations extend this flexibility to other partnerships. We believe that the legislative history to the Deficit Reduction Act of 1984 (the “Deficit Reduction Act”) 52 and Congress’s previous recognition of the potential administrative burdens that the Varying Interest Rule may impose on partnerships support this extension.

In amending the Varying Interest Rule in 1976 and 1984, Congress acknowledged that requiring partnerships to account for partner admissions and transfers on a daily basis would likely impose undue accounting complexities and administrative burdens. 53 In fact, the Senate attempted to address these concerns directly in its version of the Deficit Reduction Act by providing a statutory election for partnerships to use a monthly convention that the Senate Finance Committee explained as follows:

The bill provides for daily apportionment [under the cash basis and tiered partnership rules]; however the committee recognizes that most partnerships do not account for the admission of new partners on a daily basis and that daily apportionment of partnership income and expenses would thus result in an undue administrative burden. Accordingly, to prevent undue complexity, the bill provides, that in any case where there is a disposition of less than an entire interest in the partnership by a partner (including the entry of a new partner), the partnership may elect (on an annual basis) to determine the varying interests of the partners by using a monthly convention that treats any changes in any

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51 Prop. Reg. § 1.706-4(b)(3).
53 See, e.g., Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 (JCS-33-76), at 94 (1976) (recognizing the accounting complexity that could result from using the interim closing method for reductions in interests occurring over several days in the same month); S. REP. No. 98-169, pt. 1, at 219-221 (1984) (discussing a general rule to prevent undue administrative burdens by allowing any member entering the partnership during a month to be treated as a member for the entire month).
partner’s interest in the partnership during the taxable year as occurring on the first day of the month.\textsuperscript{54}

As enacted, the Deficit Reduction Act did not contain the Senate’s monthly convention election because the members of the Conference Committee believed that the Secretary was going to provide a similar monthly convention by Regulation.\textsuperscript{55} The Conference Report noted, however, that the Secretary would have the authority to deny the use of this monthly convention “when the occurrence of significant, discrete events (e.g., a large, unusual gain or loss) would mean that the use of [the] convention could result in significant tax avoidance.”\textsuperscript{56}

Based on the legislative history of the Deficit Reduction Act, we believe that Congress intended for there to be conventions available under the Varying Interest Rule that mitigate some of the administrative burden and accounting complexity inherent in applying the Varying Interest Rule, provided that those alternatives do not result in significant tax avoidance. While the Proposed Regulations provide relief for service partnerships and PTPs, the Proposed Regulations do not provide relief for other partnerships facing similar administrative burdens and accounting complexities.

For example, as noted above, a partnership using the interim closing method may use either the calendar day or semi-monthly convention.\textsuperscript{57} Many businesses, however, close their books on a monthly, quarterly, and/or annual basis. Thus, a business operating in the form of a partnership would have to perform additional closings if it is to use the interim closing method. These additional interim closings are likely to cause the business to incur significant additional accounting costs and administrative burdens. As these costs and the administrative burdens increase with each interim closing, so does the risk that the business simply will not comply with the requirements of the interim closing method because to comply with the requirements is impracticable.\textsuperscript{58} We believe,

\textsuperscript{54} S. REP. No. 98-169, pt.1, at 221 (1984) (emphasis added.). Despite this direct attempt by Congress to prescribe a specific method regarding the application of the Varying Interest Rule, the Secretary has broad authority to prescribe, and limit the use of, any convention, including a monthly convention. \textit{See}, e.g., I.R.C. § 706(d)(1) (giving the Secretary the authority to prescribe the methods by which partners must take into account their varying interests in the partnership during any taxable year of the partnership in which there is a change in any partner’s interest); H.R. REP. No. 98-861, at 858 (1984) (Conf. Rep.) (noting that the Secretary may provide for conventions other than a monthly convention and may also deny the use of any convention when the occurrence of significant, discrete events would result in significant tax avoidance); Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (JCS-41-84), at 222 (1984) (discussing the Secretary’s authority to prescribe the conventions available under the Varying Interest Rule).

\textsuperscript{55} H.R. REP. No. 98-861, at 858 (1984) (Conf. Rep.). Under the monthly convention that the conferees expected the Secretary to prescribe, partners entering after the 15th day of a month would have been treated as entering during the first day of the following month and partners entering during the first 15 days of a month would have been treated as entering on the first day of the month.

\textsuperscript{56} H.R. REP. No. 98-861, at 858 (1984) (Conf. Rep.); \textit{see also} Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (JCS-41-84), at 222 (1984) (asserting that use of a convention is not permitted when the occurrence of significant, discrete events would result in significant tax avoidance if the convention is used).

\textsuperscript{57} Prop. Reg. § 1.706-4(c)(2).

\textsuperscript{58} For example, a partnership using the semi-monthly convention for a sale that occurs after the 15th day of the month will likely perform a monthly closing of its books for the month that the transaction
however, that a monthly convention would generally be accommodated without significant additional accounting costs and administrative burdens.

With respect to the proration method, we agree that the proration method generally should not result in significant additional administrative burden and costs to a partnership when there are relatively few transfers of partnership interests or admissions of new partners. When a partnership using the proration method has numerous transfers and other variations in interests during a partnership taxable year, however, the partnership must compute multiple pro rations for that taxable year and those calculations can result in the same significant increases in accounting complexity and costs that arise under the interim closing method.59

For these reasons, we recommend that the final Regulations permit all partnerships to use a monthly convention subject to a requirement that the overall allocation of partnership items is reasonable. We recommend that the final Regulations provide that the allocation of partnership items using a monthly convention will not be reasonable if a principal purpose of the partnership for using the monthly convention is to reduce the present value of the partners’ aggregate tax liability.

III. Allow Each Variation to Use Different Methods and Conventions

The Proposed Regulations require the partnership and all of its partners to use the same method and convention for all variations in the partners’ interests occurring within the same taxable year of the partnership.60 While we recognize the intuitive appeal of such a rule, we believe that this conformity rule under the Proposed Regulations will be unnecessarily restrictive. On a very basic level, the method and convention adopted generally will affect only the transferor and transferee partners with respect to the distributive share of the transferred interest. As the number of partners and transfers increase, however, there are challenges with, among other things, (i) tracing the transferred interest and (ii) permitting different methods with respect to the same interest.

Nevertheless, as expressed in our first recommendation, we believe that the principles of section 706 are best administered through Regulations that provide partnerships with a reasonable degree of discretion in determining how to apply the Varying Interest Rule and that potential abuses under the Varying Interest Rule are best safeguarded against by requiring the exercise of that discretion to be reasonable. Accordingly, we recommend the final Regulations provide that partnerships and their partners may use different methods and conventions to account for variations in partners’ interests that occur in the same partnership taxable year provided that the overall

occurs and then divide the month’s results by two to determine the amounts of partnership items to allocate to the first 15 days of the month, thus using an incorrect combination of the interim closing and proration methods.

59 For example, assume partners of a partnership that is not a PTP transfer interests in the partnership on 50 different days. Under the proration method, the partnership would have to maintain 51 segments to which it would have to prorate its partnership items for that taxable year, and for which it would have to determine each partner’s interest in the items prorated to that particular segment.

60 Prop. Reg. § 1.706-4(a)(1).
allocation of partnership items is reasonable.\textsuperscript{61} We recommend that the final Regulations also provide that the overall allocation of partnership items will not be reasonable if a principal purpose of the partnership with respect to the use of the particular combination of methods and conventions is to reduce the present value of the partners’ aggregate tax liability.

IV. The Requirement to Obtain an “Agreement of the Partners”

Proposed Regulation section 1.706-4(a)(1) and (d)(1) preserve the rule of Regulation section 1.706-4(c)(2)(ii) that a partnership may use the proration method only “by agreement of the partners.” Neither the Proposed Regulations nor the preamble defines or elaborates on this phrase. The Proposed Regulations also provide that, once a partnership has selected a method and convention to apply the Varying Interest Rule, the partnership and all of its partners must use the same method and the same convention for all variations in the partners’ interests during that taxable year. Because failure to obtain an “agreement of the partners” precludes a partnership from using, or subsequently changing to, the proration method, we believe the final Regulations should specify the minimum actions that a partnership and its partners must take to obtain an “agreement of the partners.”

With respect to what actions partners must take to obtain an “agreement,” we believe the final Regulations should confirm that the partnership agreement generally dictates the section 706 method and convention the partnership must use. For this purpose, we believe that the term “partnership agreement” should have the same meaning as provided under Regulation section 1.704-1(b)(2)(ii)(h).\textsuperscript{62} Additionally, we recommend that the final Regulations also confirm that the requirement of section 761(c) that modifications of the partnership agreement be made prior to, or at, the time prescribed by law for the filing of the partnership return apply for purposes of obtaining an agreement of the partners to use the proration method.

Thus, any agreement, whether in the actual written partnership agreement or not, would satisfy an “agreement of the partners.” In addition, an agreement by the partners to use the proration method would exist if the partnership agreement (i) requires the use of the proration method or (ii) delegates the authority to select the section 706 method and convention for each variation in partners’ interests, and the delegatee subsequently selects the proration method.

\textsuperscript{61} A very common situation in which both methods are reasonable is a mid-year revaluation of the partnership’s assets due to a contribution, followed by a transfer of an interest in the partnership later in the partnership’s taxable year. In this case, the partnership might use an interim closing for the revaluation, but use the proration method for allocating the income for the remainder of the partnership taxable year between the transferor and the transferee.

\textsuperscript{62} Reg. § 1.704-1(b)(2)(ii)(h) generally provides that “the partnership agreement includes 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.”
V. **Accounting for Year-end Items Under the Interim Closing Method**

Proposed Regulation section 1.706-4(a)(2)(i) provides that a partnership using the interim closing method determines the items of income, gain, loss, deduction, and credit of the partnership for each segment in accordance with the partnership’s method of accounting for the partnership’s entire taxable year. Proposed Regulation section 1.706-4(a)(2)(i) further provides that a partnership must treat each segment as a separate distributive period.

The Proposed Regulations contain two examples illustrating the operation of these rules. The first example demonstrates that, under the interim closing method, a partnership may have 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.63 The second example demonstrates that any limitation (e.g., a section 179 limitation) applicable to the partnership taxable year as a whole must be apportioned among the segments in amounts that do not exceed the total limitation for the taxable year.64

Even with these examples, it is not clear how a partnership should account for items that typically are not determined until the end of the taxable year, such as waterfall allocations, minimum gain chargebacks, and certain reserves. Specifically, it is not clear whether these analyses should be performed at the interim closing dates or the end of the partnership’s taxable year. We recommend that the final Regulations include guidance regarding the proper accounting under the interim closing method for items that either (i) are not determined until the end of the taxable year and do not relate to any discrete event that occurred during the taxable year or (ii) require an analysis of, or are conditioned on, the results for the entire taxable year.

We also recommend more generally that the Treasury and the Service clarify the interaction between sections 704(b) and 706(d) in future guidance. The current Regulations under sections 704(b) and 706(d) do not adequately address the interaction between these provisions.65 Very generally, Regulation section 1.704-1(b)(1)(i) provides that allocations of partnership items to a partner provided by a partnership agreement will be respected under section 704(b) if the allocations (i) have substantial economic effect,

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65 Additionally, the current Regulations do not adequately address how section 706(d) interacts with other provisions outside of subchapter K of the Code. For example, the interaction of sections 706(d), 704(b), and 108(i) is not clear. Take the following example, S sells its interest in PRS to Y on July 5. Assume that the partnership has cancellation of indebtedness income ("COD income") from a discharge of indebtedness on July 2. For a partnership using the interim closing method and adopting the semi-monthly convention, the transferor partner would not be allocated any portion of the COD income despite being a partner in the partnership on the day that the debt was discharged. While the result in this example under the semi-monthly convention arguably is inconsistent with the intent of section 108(i), we believe Congress should be imputed with the knowledge of section 706 and its impact on the allocation of partnership items among partners. See I.R.C. § 108(i)(6) (providing that, in the case of a partnership, any income deferred under section 108(i) must be allocated to the partners in the partnership immediately before the discharge in the manner the amounts would have been included in the distributive shares of the partners under section 704 if the income were recognized at that time).
(ii) are in accordance with the partner’s interest in the partnership, or (iii) are deemed to be in accordance with the partner’s interest in the partnership under certain provisions of the Regulations under section 704(b). Regulation section 1.704-1(b)(1)(iii) generally provides, however, that an allocation that is respected under section 704(b) may nevertheless be reallocated under other provisions, such as section 706(d). When a provision, such as section 706(d), requires reallocation of partnership items, it is not clear what effect the reallocation has on the application of the provisions of section 704(b), particularly with respect to the capital account maintenance provisions. For this reason, we recommend that the Treasury and the Service issue guidance to clarify the interaction between sections 704(b) and 706(d).

VI. The Scope and Application of the Conditions to Change Existing Sharing Percentages

We support the Treasury and the Service’s decision to confirm by Regulation that the Varying Interest Rule does not apply to changes in the allocations among partners who were members of the partnership for the entire taxable year of the partnership provided the changes did not result from a capital contribution (the “Reallocation Rule”). The Reallocation Rule under the Proposed Regulations has two conditions that a partnership and its partners must satisfy to exempt the retroactive allocations from the Varying Interest Rule. First, the changes may not be attributable to a capital contribution to or distribution from the partnership, and second, the changes must satisfy the requirements of section 704(b).

While the rationale of the Reallocation Rule under the Proposed Regulations is clear, the scope and application of its conditions are not. Among the uncertainties are when changes in the allocations among partners are attributable to capital contributions to, and distributions from, the partnership and what requirements of section 704(b) must be satisfied. For example, is a change in allocations among partners attributable to any non-pro rata distribution from a partnership? If the partners would have agreed to the change even if no contribution or distribution had been made, does that establish that the change is not attributable to the contribution or distribution? Is a partner’s agreement to a deficit restoration obligation a “capital contribution” for this purpose? Given the generality of the rule, we recommend that the final Regulations provide guidance clarifying when changes are attributable to capital contributions to, and distributions from, a partnership for purposes of the Reallocation Rule. To this end, we recommend that the final Regulations provide that changes are attributable to capital contributions or distributions if the retroactive allocation would not have been made but for the contribution or distribution. Additionally, we recommend that the final Regulations

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66 See, e.g., Lipke v. Commissioner, 81 T.C. 689 (1983) (holding that section 706(c)(2)(B), as in effect before the Deficit Reduction Act, did not prohibit the retroactive reallocation of losses among partners who were members of the partnership for the entire taxable year, provided that the reallocation of losses was not made in consideration for additional capital contributions); S. REP. No. 98-168, pt. 1, at 219 (1984) (clarifying that the Deficit Reduction Act was not intended to override the longstanding rule of section 761(c) with respect to interest shifts among partners who were members of the partnership for the entire taxable year, provided the shifts are not attributable to capital contributions).

provide that the change in allocations among partners satisfy the requirements of section 704(b) if the allocations are valid under section 704(b).

Moreover, we recommend that the final Regulations expand the scope of the Reallocation Rule to apply not only among partners who were members of the partnership for the entire taxable year but also among partners who were members of the partnership for an entire segment. For example, P, R, and S form a partnership on January 1, and on July 1, the partnership admits Y as a partner. Section 761(c) and the Proposed Regulations allow retroactive allocations among P, R, and S for the entire taxable year. We believe, however, that the final Regulations also should allow retroactive allocations among P, R, S, and Y with respect to the items allocable to the July 1 through December 31 segment.

VII. General Observations Regarding Cash Basis Items and Tiered Partnerships

As noted above, section 706(d)(2) and section 706(d)(3) provide special rules under the Varying Interest Rule with respect to the treatment of “allocable cash basis items” and the allocation of partnership items when a partner’s interest changes in a partnership that, itself, is a partner in another partnership. Briefly, section 706(d)(2) provides that a partner’s distributive share of any “allocable cash basis item,” as that term is defined in section 706(d)(2)(B), is determined by assigning a pro rata share of any allocable cash basis item to each day within a specified period to which it is attributable and then allocating each day’s portion in an amount equivalent to each partner’s interest in the partnership on that day.\(^68\) Section 706(d)(3) generally provides a rule for tiered partnerships that if during any taxable year of an upper-tier partnership (“UTP”) there is a change in any partner’s interest in the UTP and UTP is a partner in another lower-tier partnership (“LTP”), then, except to the extent provided by Regulations, each partner’s distributive share of any item of UTP attributable to LTP is determined by first assigning the appropriate portion of each item to the appropriate days during which UTP is a partner in LTP and then allocating the portion assigned to any day among the partners in proportion to their interests in UTP at the close of that day.\(^69\)

Neither case law nor administrative guidance provides significant guidance with respect to either of these provisions or their purposes. We suggest that the Treasury and the Service issue guidance interpreting these provisions and clarifying their intended purposes. We have summarized our general observations and look forward to the opportunity to comment more substantively on these topics when future guidance is issued.

1. Because section 706(d)(2) imposes the same administrative burden on partnerships regardless of the percentage of the partnership’s total expenses that “allocable cash basis items” represents for the taxable year, we believe that section 706(d)(2) should contain a de minimis rule.


\(^69\) Id.
2. We believe that future guidance should clarify that section 706(d)(2) applies only to items of deduction and loss, and not also to items of income and gain.

3. Obtaining information from a LTP to track multiple changes in the ownership interests of partners in an UTP is burdensome and, in many cases, impractical unless the UTP controls the LTP. To address these rules, we believe the default rule for allocating LTP items among partners of the UTP should be a proration method unless the UTP chooses to use an interim closing method (or account separately for LTP extraordinary items) and receives sufficient information for the LTP to use the chosen method.

Given the potential hardship of complying with the requirements of section 706(d)(3) when a UTP does not have a controlling interest in an LTP, we recommend that interim guidance be issued providing that, until guidance is issued under section 706(d)(3), section 706(d)(3) does not apply to a change of a partner’s interest in a UTP unless the UTP owns more than 50% of the profits and capital of an LTP.