[4830-01-P]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9728]

RIN 1545-BD71

Determination of Distributive Share When Partner's Interest Changes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding the determination of a partner's distributive share of partnership items of income, gain, loss, deduction, and credit when a partner's interest varies during a partnership taxable year. The final regulations also modify the existing regulations regarding the required taxable year of a partnership. These final regulations affect partnerships and their partners.

DATES: Effective date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability date: For dates of applicability, see §§1.706-1(b)(6)(v), 1.706-1(d), 1.706-4(g), and 1.706-5(b).

FOR FURTHER INFORMATION CONTACT: Benjamin H. Weaver of the Office of Associate Chief Counsel (Passthroughs and Special Industries) at (202) 317-6850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this Treasury decision has been submitted to the OMB for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by [**INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**]. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in the final regulations are in §1.706-4(f), which requires partnerships adopting the proration method, adopting the semi-monthly or monthly convention, choosing to perform semi-monthly or monthly interim closings, or selecting an additional class of extraordinary items, to maintain a statement with their books and records. This information will be available to the IRS upon examination to document the partnership's selection of the method, convention, optional interim closings, or additional class of extraordinary items. The collections of information are required to obtain a benefit. The likely respondents are partnerships. The collections will be reported and collected through the OMB approval number for Form 1065, U.S. Return of Partnership Income, under control number 1545-0123; please see the instructions for Form 1065 for estimates of the burden associated with the collection of information.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the OMB.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

Background

These final regulations contain amendments to the Income Tax Regulations (26 CFR Part 1) under section 706 of the Internal Revenue Code (Code). On April 14, 2009, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-144689-04) (the 2009 proposed regulations) in the **Federal Register** to provide guidance under section 706(d)(1) and to conform the Income Tax Regulations for certain provisions of section 1246 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788 (1997)), and section 72 of the Deficit Reduction Act of 1984, Public

Law 98-369 (98 Stat. 494 (1984)). The Treasury Department and the IRS did not hold a public hearing because there were no requests to speak at a hearing. However, the Treasury Department and the IRS received comments in response to the 2009 proposed regulations. The comments are discussed in this preamble.

The 2009 proposed regulations provided methods for determining partners' distributive shares of partnership items in any year in which there is a change in a partner's interest in the partnership, whether by reason of a disposition of the partner's entire interest or less than the partner's entire interest, or by reason of a reduction of a partner's interest due to the entry of a new partner or partners. The 2009 proposed regulations also added proposed §1.706-1(c)(2)(iii) to provide that a deemed disposition of a partner's interest pursuant to §§1.1502-76(b)(2)(vi) (relating to corporate partners that become or cease to be members of a consolidated group within the meaning of §1.1502-1(h)), 1.1362-3(c)(1) (relating to the termination of the subchapter S election of an S corporation partner), or 1.1377-1(b)(3)(iv) (regarding an election to terminate the taxable year of an S corporation partner) shall be treated as a disposition of the partner's entire interest in the partnership. Finally, the 2009 proposed regulations amended the rules applicable to the determination of the taxable year of a partnership when a partnership interest is held by a "disregarded foreign partner" (as defined in §1.706-1(b)(6)(i)).

After consideration of the comments, the 2009 proposed regulations are adopted as modified by this Treasury decision.

Explanation of Provisions and Summary of Comments

1. Varying Interests Rule

The 2009 proposed regulations under §1.706-4 provided guidance under section 706(d)(1), which provides that, except as required by section 706(d)(2) and (d)(3), if there is a change in a partner's interest in the partnership during the partnership's taxable year, each partner's distributive share of any partnership item of income, gain, loss, deduction, or credit for such taxable year is determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year. The 2009 proposed regulations incorporated several of the existing varying interest rules in the regulations under section 706. These final regulations finalize the varying interest rules contained in the 2009 proposed regulations with the modifications described in this Part 1 of the preamble. The Treasury Department and the IRS have decided that these modifications necessitate reorganizing §1.706-4 for clarity. As finalized by these regulations, §1.706-4(a)(3) now contains a step-by-step process for making allocations under §1.706-4. In addition, the remainder of §1.706-4 has been reorganized into discrete sections addressing the scope of §1.706-4, exceptions to §1.706-4, partnership conventions, extraordinary items, and procedures for partnership decisions relating to §1.706-4. Where possible, this preamble tracks the organization of §1.706-4 as finalized by these regulations.

A. Scope of §1.706-4

Section 1.706-4 of the final regulations provides rules for determining the partners' distributive shares of partnership items when a partner's interest in a partnership varies during the taxable year as a result of the disposition of a partial or entire interest in a partnership as described in §1.706-1(c)(2) and (c)(3), or with respect to a partner whose interest in a partnership is reduced as described in §1.706-1(c)(3), including by the entry of a new partner (collectively, a "variation"). The final regulations further provide that, in all cases, all partnership items for each taxable year must be allocated among the partners, and no items may be duplicated, regardless of the particular provision of section 706 which applies, and regardless of the method or convention adopted by the partnership.

The 2009 proposed regulations contained two exceptions for allocations that would otherwise be subject to the rules of §1.706-4: one exception applies to certain partnerships with contemporaneous partners, and the other exception applies to certain service partnerships. As described below, the final regulations adopt these exceptions with certain modifications.

The 2009 proposed regulations did not address the interaction of the allocable cash basis item rules of section 706(d)(2) and the tiered partnership rules of section 706(d)(3) with the rules in §1.706-4 for determining a partner's distributive share when a partner's interest varies. However, the 2009 proposed regulations did request comments on issues that arise with regard to allocable cash basis items and tiered partnerships. In response to comments received, §§1.706-2 and 1.706-3 are proposed to be amended as described in a notice of proposed rulemaking issued contemporaneously with these final regulations to address the treatment of allocable cash basis items and tiered partnerships, respectively. The final regulations clarify that §1.706-4 does not apply to items subject to allocation under other rules, including section 706(d)(2) and section 706(d)(3).

i. Permissible changes among contemporaneous partners

The 2009 proposed regulations contained a "contemporaneous partner exception" based on the Tax Court's opinion in Lipke v. Commissioner, 81 T.C. 689 (1983), and the legislative history of section 706. 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). In Lipke, the Tax Court held that section 706(c)(2)(B) (as in effect prior to 1984) prohibited retroactive allocations of partnership losses when the allocations resulted from additional capital contributions made by both new and existing partners. However, the Tax Court held that the prohibition on retroactive allocations under section 706(c)(2)(B) did not apply to changes in the allocations among partners that were members of the partnership for the entire year (contemporaneous partners) if the changes in the allocations did not result from capital contributions. Congress amended section 706 in 1984, in part to clarify that the varying interests rule applies to any change in a partner's interest, whether in connection with a complete disposition of the partner's interest or otherwise. To that end, Congress replaced the varying interests rule in section 706(c)(2)(B) with the rule that now appears in section 706(d)(1). The legislative history pertaining to this amendment reflects Congress's intention that the new rule of section 706(d)(1) be comparable to the pre-1984 law without overruling the longstanding rule of section 761(c):

> The committee wishes to make clear that the varying interests rule is not intended to override the longstanding rule of section 761(c) with respect to interest shifts among partners who are members of the partnership for the entire taxable year, provided such shifts are not, in substance, attributable to the influx of new capital from such partners. *See* Lipke v. Commissioner, 81 T.C. 689 (1983).

S. Prt. 98–169, Vol. I, 98th Cong., 2d Sess. 218–19 (1984); see also H. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1212–13 (1984) (containing similar language).

Consistent with this authority, proposed §1.706-4(b)(1) provided an exception to the rule in proposed §1.706-4(a)(1) for dispositions of less than a partner's entire interest in the partnership described in §1.706-1(c)(3), provided that the variation in the partner's interest is not attributable to a capital contribution or a partnership distribution to a partner that is a return of capital, and the allocations resulting from the modification otherwise comply with section 704(b) and the regulations promulgated thereunder.

Commenters requested guidance on determining when changes in the allocations among partners are attributable to capital contributions to, and distributions from, the partnership, and which requirements of section 704(b) must be met. The final regulations do not address the determination of whether an amended allocation is attributable to a contribution or a distribution to a partner or whether such allocations otherwise satisfy section 704(b) because these comments raise issues beyond the scope of this project and require further consideration. However, the Treasury Department and the IRS may address these issues in future guidance.

Commenters also requested that the final regulations expand the scope of the contemporaneous partner exception to include allocations of items attributable solely to a particular segment of a partnership's year (see §1.706-4(a)) among partners who are partners of the partnership for that entire segment. The final regulations adopt this recommendation and finalize the contemporaneous partner exception.

ii. <u>Safe harbor for partnerships for which capital is not a material income-producing factor</u>

Proposed §1.706-4(b)(2) provided that a service partnership (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) may choose to determine the partners' distributive shares of partnership income, gain, loss, deduction, and credit using any reasonable method, provided that the allocations were valid under section 704(b). Commenters recommended the final regulations extend the safe harbor to non-service partnerships that satisfy specific revenue and allocation thresholds (for example, gross receipts of $100 million or less and no partner receives an allocation of an item listed under section 702(a) in excess of $10 million). Another commenter requested that the final regulations provide that the list of service partnerships could be expanded by other published guidance.

The Treasury Department and the IRS intend the safe harbor for service partnerships to be limited to partnerships that derive their income from the provision of services and not from capital because, in general, allocations among individual partners in partnerships for which capital is not a material income-producing factor do not raise concerns that may be present in allocations among partners in capital-intensive partnerships. Therefore the final regulations do not provide an exception based upon revenue and allocation thresholds. However, the Treasury Department and the IRS agree that the definition of a service partnership in the proposed regulations was overly narrow. Accordingly, the final regulations apply the service partnership safe harbor to any partnership for which capital is not a material income-producing factor.

B. Varying Interest Rule Methods: Interim Closing and Proration

The 2009 proposed regulations generally provided that a partnership shall take into account any variation in the partners' interests in the partnership during the taxable year in determining the distributive share of partnership items under section 702(a) by using either the interim closing method or the proration method. Unless the partners agree to use the proration method, the partnership was required to use the interim closing method and allocate its items among the partners in accordance with their respective partnership interests during each segment of the taxable year. Under the 2009 proposed regulations, if the partners agreed to use the proration method, the partnership was required to allocate the distributive share of partnership items among the partners in accordance with their pro rata shares of the items for the entire taxable year. The 2009 proposed regulations did not, however, allow certain "extraordinary items" to be prorated, and instead required that those items be allocated according to special rules. These regulations finalize the method rules of the 2009 proposed regulations with certain modifications.

i . Use of more than one method and convention during the same taxable year.

Proposed §1.706-4(a)(1) required the partnership and all of its partners to use the same method for all variations in the partners' interests occurring within the partnership's taxable year, whether resulting from a complete or partial termination of a partner's interest or the entry of a new partner. Commenters recommended that the final regulations allow a partnership to use different methods for separate variations during the partnership's taxable year, provided that the overall combination of methods is reasonable based on the overall facts and circumstances. Commenters stated that it would be 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 the 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 are unwilling to bear the costs of closing the books), in order to minimize the costs and administrative burden of accounting for such transfers. The Treasury Department and the IRS agree that partnerships may be more willing to use the interim closing method, which is generally more accurate but more costly, for significant variations if doing so would not require the partnership to use the interim closing method for all variations, regardless of size, that occur throughout the year. Therefore, in response to comments, the final regulations allow a partnership to use different methods for different variations within the partnership's taxable year, as explained in Part 1.B.iii of this Preamble. Accordingly, a partnership may use the interim closing method with respect to one variation and may choose to use the proration method for another variation in the same year. However, the final regulations provide that the Commissioner may place restrictions on the ability of a partnership to use different methods during the same taxable year in guidance published in the Internal Revenue Bulletin.

ii. Optional regular monthly or semi-monthly interim closings.

The 2009 proposed regulations require partnerships applying the interim closing method to perform the interim closing at the time the variation is deemed to occur, and do not require or permit a partnership to perform an interim closings of its books except at the time of any variation for which the partnership uses the interim closing method.

One commenter stated that of the partnerships that close their books at times other than year end, most do so at month end, and some close their books semi-monthly. The commenter stated that most partnerships that currently are subject to the interim closing method do not actually close their books other than at month end as they do not have the resources and systems organized in order to do that. The commenter requested that partnerships using the interim closing method and the calendar day convention be allowed under the final regulations to determine income on a calendar day basis by closing their books at month's end, and then prorating the last month's income to the periods of the month before and after the calendar day on which the variation occurred.

The Treasury Department and the IRS agree that partnerships should be permitted to perform regular monthly or semi-monthly interim closings, and to prorate items within each month or semi-month, as applicable. Therefore, the final regulations provide that a partnership may, by agreement of the partners, perform regular interim closings of its books on a monthly or semi-monthly basis, regardless of whether any variation occurs. The Treasury Department and the IRS believe that this combination of the use of regular interim closings and the proration method with respect to variations should generally achieve the results sought by the commenter. The final regulations continue to require a partnership using the interim closing method with respect to a variation to perform the interim closing at the time the variation is deemed to occur, and do not require a partnership to perform an interim closings of its books except at the time of any variation for which the partnership uses the interim closing method.

The final regulations provide guidance on the meaning of the term "agreement of the partners," including for purposes of the decision to perform regular monthly or semi-monthly interim closings. Because that term applies to several different decisions in §1.706-4, the discussion of "agreement of the partners" is consolidated into Part 1.E of this preamble.

iii. Segments and Proration Periods

For purposes of accounting for the partners' varying interests in the partnership, the 2009 proposed regulations required the partnership to maintain, for each partner whose interest changes in the taxable year, segments to account for such changes. Under the 2009 proposed regulations, a segment was a specific portion of a partnership's taxable year created by a variation, regardless of whether the partnership used the interim closing method or the proration method for that variation. The final regulations continue to rely on the concept of segments; however, because the final regulations now permit partnerships to use both the interim closing method and the proration method in the same taxable year, the final regulations also contain a new concept of proration periods. Under the final regulations, segments are specific periods of the partnership's taxable year created by interim closings of the partnership's books, and proration periods are specific portions of a segment created by a variation for which the partnership chooses to apply the proration method. The partnership must divide its year into segments and proration periods, and spread its income among the segments and proration periods according to the rules for the interim closing method and proration method, respectively.

Under the final regulations, the first segment commences with the beginning of the taxable year of the partnership and ends at the time of the first interim closing of the partnership's books. Any additional segment shall commence immediately after the closing of the prior segment and ends at the time of the next interim closing. However, the last segment of the partnership's taxable year ends no later than the close of the last day of the partnership's taxable year. If there are no interim closings, the partnership has one segment, which corresponds to its entire taxable year.

Under the final regulations, the first proration period in each segment begins at the beginning of the segment, and ends at the time of a variation for which the partnership uses the proration method. The next proration period begins immediately after the close of the prior proration period and ends at the time of the next variation for which the partnerships uses the proration method. However, each proration period ends no later than the close of the segment. Thus, segments close proration periods. Therefore, the only items subject to proration are the partnership's items attributable to the segment containing the proration period.

a. Rules for determining the items in each segment

Proposed §1.706-4(a)(2)(i) required that a partnership using the interim closing method treat each segment as though the segment was a separate distributive share period and that therefore a partnership using the interim closing method may compute a capital loss for a segment of a taxable year even though the partnership has a net capital gain for the entire taxable year. Similarly, proposed §1.706-4(a)(2)(ii) provided that any 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 apportioned among the segments using any reasonable method, provided that the total amount of the items apportioned among the segments does not exceed the limitation applicable to the partnership year as a whole.

Commenters expressed concern that the examples do not clarify how a partnership accounts for items that are not determined until the end of the taxable year, such as waterfall allocations, minimum gain chargebacks, and certain reserves. Commenters specifically inquired whether these determinations are made at the interim closing dates or at the end of the partnership's taxable year. Other commenters questioned whether the distributive share periods are treated as separate taxable years for purposes of sections 461(h) (relating to economic performance) and 404(a)(5) (relating to deductions for contributions to employee plans). Finally, other commenters requested guidance on the interaction of sections 168 (relating to the modified accelerated cost recovery system) and 471 (relating to accounting for inventories) with the 2009 proposed regulations.

Proposed §1.706-4(a)(2)(i) and (ii) were intended to demonstrate that year-end determinations and annual limitations are evaluated only at the end of the partnership's taxable year. The final regulations continue to provide that each segment is generally treated as a separate distributive share period. Additionally, the final regulations provide that for purposes of determining allocations to segments, any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year will be applied based on the partnership's satisfaction of the limitation or requirements as of the end of the partnership's taxable year. For example, the expenses related to the election to expense a section 179 asset must first be calculated (and limited if applicable) based on the partnership's full taxable year, and then the effect of any limitation must be apportioned among the segments in accordance with the interim closing method or the proration method using any reasonable method. Thus, the segments are not treated as separate taxable years for purposes of sections 461(h) and 404(a)(5). The final regulations do not address inventory accounting under section 471 because those issues are beyond the scope of this project.

Moreover, other provisions of the Code providing a convention for making a particular determination still apply. For example, section 168 provides conventions for determining when property is placed in service and when property is disposed of. The convention in section 168 would apply first to determine when the property is placed in service or when the property is disposed of, and section 706 would apply second to determine who was a partner during that segment. The Treasury Department and the IRS are studying issues relating to the interaction of section 706 and the partnership minimum gain provisions in §1.704-2 and therefore the final regulations do not address these issues. As discussed in Part 1.F of this preamble, the interaction of sections 704 and 706 is generally beyond the scope of these final regulations; accordingly, these final regulations do not address the treatment of waterfall allocations.

b. Determining the items in each proration period

Under the 2009 proposed regulations, if the partners agreed to use the proration method, the partnership was required to allocate the distributive share of partnership items among the partners in accordance with their pro rata shares of the items for the entire taxable year. The Treasury Department and the IRS received several comments suggesting various modifications to the proration method. Commenters stated that the 2009 proposed regulations provided less flexibility in accounting for partners' varying interests under the proration method than the current regulations under section 706.

Commenters recommended that the final regulations retain the flexibility of the current regulations by allowing partnerships to use any reasonable proration method to determine partners' distributive shares of partnership items and that the final regulations provide examples of reasonable proration methods. The Treasury Department and the IRS believe that, because the final regulations provide partnerships with flexibility to use either the interim closing method or the proration method for each variation, and because the proration method can be less accurate than the interim closing method, it is appropriate to generally retain the rules applicable to the proration method from the 2009 proposed regulations. Accordingly, the final regulations do not adopt this suggestion. However, because the final regulations permit partnerships to use both the proration method and the interim closing method in the same taxable year, the rules for the proration method are now based upon the items in each segment, rather than the items for the partnership's entire taxable year. Section 1.706-4(a)(4) of the final regulations contains a detailed example illustrating the interaction of segments and proration periods.

Proposed §1.706-4(d)(1) provided that, for purposes of the proration method, specific items 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. Commenters questioned whether proposed §1.706-4(a)(2)(i) and (ii) and (d)(1) were intended to provide the same rules for both the interim closing method and the proration method. These sections address different issues. Proposed §1.706-4(d)(1) was intended to allow partnerships that have multiple items that are aggregated by the partnership at the end of the year to also treat those items as a single item for purposes of the proration method (for example, capital gains and capital losses). By contrast, proposed §1.706-4(a)(2)(i) and (ii) were intended to demonstrate that for purposes of determining allocations to segments, any annual limitation will be disregarded as long as the limitation is satisfied by the end of the partnership's taxable year.

One commenter requested that the final regulations allow publicly traded partnerships (as defined in section 7704(b)) that are treated as partnerships ("PTPs") using the proration method and calendar day convention to prorate their annual aggregate tax items by the number of months instead of the number of days. Because the use of the proration method can be less accurate than the interim closing method in certain circumstances, the Treasury Department and the IRS believe that partnerships using the proration method should prorate by the number of days. Therefore, the final regulations do not adopt this recommendation.

iv. Agreement of the partners to use the proration method

Consistent with the 2009 proposed regulations, under the final regulations the proration method may be used only by "agreement of the partners." Commenters requested guidance on the meaning of this term, and the final regulations provide guidance as described in Part 1.E of this preamble.

C. Varying Interest Rule Conventions: Calendar Day, Semi-Monthly, and Monthly

The 2009 proposed regulations acknowledged that for certain partnerships using the interim closing method, such as partnerships in which interests are frequently transferred, determining the partnership items for each segment could create a significant administrative burden. Accordingly, the 2009 proposed regulations allowed the use of simplifying conventions. Conventions are rules of administrative convenience that determine when each variation is deemed to occur for purposes of §1.706-4. Because the timing of each variation determines the partnership's segments and proration periods, which in turn are used to determine the partners' distributive shares, the convention used by the partnership with respect to a variation will generally affect the allocation of partnership items. However, as discussed in Part 1.D.ii of this preamble, extraordinary items generally must be allocated without regard to the partnership's convention.

The 2009 proposed regulations provided that a partnership using the interim closing method could use either the calendar day convention or the semi-monthly convention to determine the segments of the partnership's taxable year, and provided that a partnership using the proration method shall use the calendar day convention. The 2009 proposed regulations required the partnership to use the same convention for all variations during a taxable year. The 2009 proposed regulations requested comments with regard to the possible expansion of these rules to include other conventions or other methods. The final regulations generally finalize the rules for conventions from the 2009 proposed regulations with the modifications described in this Part 1.C of the preamble.

i. Allowance of monthly conventions

Commenters noted that the legislative history of section 706(d) contemplated that regulations under section 706 would provide a monthly convention for all partnerships. These commenters also argued that the administrative burden and accounting complexity inherent in the interim closing method would be alleviated by a monthly convention. Accordingly, the commenters recommended that the monthly convention be available to all partnerships, regardless of method, provided that the overall allocation of partnership items is reasonable.

The legislative history indicates that Congress did consider providing for a statutory election to use a monthly convention:

> [T]o 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 partner's interest in the partnership during the taxable year as occurring on the first day of the month.

S. REP. NO. 98-169, at 221 (1984). However, this statutory provision was not enacted and the House-Senate Conference Committee report explains that it was omitted because Congress expected the Secretary to provide for a monthly convention by regulation. H.R. REP. NO. 98-861, at 858 (1984). In accordance with this Congressional intent, the final regulations provide that any partnership using the interim closing method (but not partnerships using the proration method) may use a monthly convention to account for partners' varying interests. Under the monthly convention, in the case of a variation occurring on the first through the 15th day of a calendar month, the variation is deemed to occur for purposes of §1.706-4 at the end of the last day of the immediately preceding calendar month. And in the case of a variation occurring on the 16th through the last day of a calendar month, the variation is deemed to occur for purposes of §1.706-4 at the end of the last day of that calendar month.

Consistent with the rules for the selection of the proration method, the final regulations provide that the selection of the convention must be made by agreement of the partners by satisfying the provisions of §1.706-4(f) of these final regulations as explained in Part 1.E of this preamble. In the absence of an agreement to use a convention, the partnership will be deemed to have chosen the calendar day convention.

ii. Convention for partnerships using the proration method

Commenters also requested that the final regulations allow partnerships using the proration method to allocate extraordinary items under either the calendar day convention or the semi-monthly convention to mirror the rules under the interim closing method. As explained in Part 1.D.i of this preamble, the final regulations provide that extraordinary items must generally be allocated based on the date and time on which the extraordinary items arise, without regard to the partnership's convention or use of the proration method or interim closing method. Thus, under the final regulations the allocation of extraordinary items will generally be the same regardless of the partnership's selected method or convention.

The partnership's method and convention are generally relevant in determining allocations of non-extraordinary items. The final regulations retain the requirement that partnerships using the proration method must use a calendar day convention. Partnerships using the interim closing method have the option of using a semi-monthly or monthly convention in addition to the calendar day convention because of the additional administrative burdens inherent in using the more accurate interim closing method. Although the proration method may impose less administrative burdens on a partnership, it is less accurate than the interim closing method. Thus, the Treasury

Department and the IRS believe it is necessary to retain the requirement of a calendar day convention for the proration method.

iii. Conventions for PTPs

Proposed §1.706-4(b)(3) provided a safe harbor for PTPs that permitted a PTP using either the interim closing method or the proration method to treat all transfers of its publicly traded units (as described in §1.7704-1(b)(1)) except for certain block transfers during the calendar month as occurring, for purposes of determining partner status, on the first day of the following month under a consistent method adopted by the partnership. Proposed §1.706-4(b)(3) also provided that, alternatively, PTPs could use the semi-monthly convention described in proposed §1.706-4(e)(2). The proposed PTP safe harbor referenced both rules for determining partner status and conventions in the same sentence, which could cause confusion. To eliminate this confusion, the Treasury Department and the IRS have decided to incorporate the rules of the PTP safe harbor from the 2009 proposed regulations, modified in response to comments as described in this section of the preamble, into the portions of the regulations providing rules for partnership conventions and methods. Therefore, the PTP safe harbor from the 2009 proposed regulations is no longer necessary and has been removed from the final regulations. However, as described below, the substantive rules from the PTP safe harbor remain largely unchanged in these final regulations.

Commenters on the PTP safe harbor recommended that PTPs should be able to apply their conventions to all transfers of units, not just publicly traded units, including block transfers. The IRS and the Treasury Department agree that the rules from the proposed regulations should be extended to block transfers, but believe that transfers of non-publicly traded units should be accounted for similar to transfers of interests in non-publicly traded partnerships. Accordingly, the final regulations provide that a PTP may, by agreement of the partners, use any of the calendar day, the semi-monthly, or the monthly convention with respect to all variations during the taxable year relating to its publicly-traded units, regardless of whether the PTP uses the proration method with respect to those variations. A PTP must use the same convention for all variations during the taxable year relating to its publicly traded units. The final regulations provide that a PTP must use the calendar day convention with respect to all variations relating to its non-publicly traded units for which the PTP uses the proration method. In addition, consistent with the rules from the PTP safe harbor in the 2009 proposed regulations, the final regulations provide that a PTP using a monthly convention generally may consistently treat all variations occurring during each month as occurring at the end of the last day of that calendar month, if the PTP uses the monthly convention for those variations.

The preamble to the 2009 proposed regulations acknowledged that some PTPs use conventions not described in the 2009 proposed regulations and requested comments concerning the use of additional conventions. In response to this request for comments, one commenter on the PTP safe harbor also recommended that the final regulations allow PTPs to use a quarterly convention. This commenter stated that PTPs generally declare cash distributions quarterly to their unit holders of record on the last day of the quarter to align the distributions with the PTPs' quarterly financial reporting. The Treasury Department and the IRS believe that a quarterly convention could significantly reduce the accuracy of the allocations of a partnership's tax items to a particular partner. Accordingly, the final regulations do not permit PTPs to use a quarterly convention. As discussed in Part 1.D.iii.a of this preamble, however, proposed regulations under section 706 (REG-109370-10) are being published concurrently with these final regulations, and, subject to certain exceptions, provide that PTPs may, by agreement of their partners, treat all items of income that are amounts subject to withholding as defined in §1.1441-2(a) (excluding income effectively connected with the conduct of a trade or business within the United States) or withholdable payments under §1.1473-1(a) as extraordinary items. If the partners so agree, then for purposes of section 706 such items are treated as occurring at the next time as of which the recipients of a distribution by the PTP are determined, or, to the extent such income items arise between the final time during the taxable year as of which the recipients of a distribution are determined and the end of the taxable year, such items shall be treated as occurring at the final time during the taxable year that the recipients of a distribution by the PTP are determined. This proposed rule does not apply unless the PTP has a regular practice of making at least four distributions (other than de minimis distributions) to its partners during each taxable year. The Treasury Department and the IRS believe that this proposed rule is desirable to link each partner's distributive share to the related cash distributions, thereby enabling PTPs and their transfer agents to satisfy their withholding obligations under chapter 4 of the Code and under sections 1441 through 1443 from distributions.

The convention rules in proposed §1.706-4(c)(2) and (d)(2) did not apply to existing PTPs (existing PTP exception). Solely for purposes of the 2009 proposed regulations, an existing PTP was a partnership described in section 7704(b) that was formed on a date before the 2009 proposed regulations were published. Commenters noted that an existing PTP that terminates under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits (a “technical termination”) on or after the publication of the 2009 proposed regulations would not receive the benefit of the existing PTP exception. These commenters noted that a technical termination is a tax concept and does not result in any changes to the partnership agreement, including any provisions relating to section 706(d). Commenters also noted that disregarding technical terminations of PTPs would be consistent with other regulation provisions (such as §1.731-2(g)(2), which provides that a successor partnership formed as a result of technical termination is disregarded for purposes of applying section 731(c)). The final regulations adopt this recommendation and provide that, for purposes of the effective date provision, the termination of a PTP under section 708(b)(1)(B) is disregarded in determining whether the PTP is an existing PTP.

iv. Use of more than one convention during a taxable year

The 2009 proposed regulations required the partnership to use the same convention for all variations during a taxable year. Because the final regulations permit partnerships to use both the proration and interim closing methods during a taxable year, the final regulations provide that the partnership and all of its partners must use the same convention for all variations for which the partnership chooses to use the interim closing method. Furthermore, because PTPs are also permitted to use the semi-monthly and monthly conventions with respect to variations for which the PTP uses the proration method, the final regulations provide that PTPs must use the same convention for all variations during the taxable year.

v. Deemed timing of variations

Under the semi-monthly convention in the 2009 proposed regulations, the first segment of the partnership's taxable year commenced with the beginning of the partnership's taxable year, and with respect to a variation in interest occurring on the first through the 15th day of the month, was deemed to close at the end of the last day of the immediately preceding calendar month. Thus, although the 2009 proposed regulations provided that the first segment commences with the beginning of the partnership's taxable year, they also provided that a variation occurring on the first through the 15th day of the first calendar month of the partnership's taxable year was deemed to close at the end of the last day of the immediately preceding calendar month, which would be the last day of the prior taxable year. The final regulations provide that all variations within a taxable year are deemed to occur no earlier than the first day of the partnership's taxable year, and no later than the close of the final day of the partnership's taxable year. Thus, under the semi-monthly or monthly convention, a variation occurring on January 1st through January 15th for a calendar year partnership will be deemed to occur for purposes of §1.706-4 at the beginning of the day on January 1. The conventions are not applicable to a sale or exchange of an interest in the partnership that causes a termination of the partnership under section 708(b)(1)(B); instead, such a sale or exchange will be considered to occur when it actually occurred.

vi. Exception for admission to and exit from the partnership within a convention period

The Treasury Department and the IRS recognize that, while the conventions are rules of administrative convenience that simplify the partnership's determination of the partners' distributive shares, the application of the conventions could result in some partners not being allocated any share of partnership items at all. For example, under the monthly convention, if a new partner buys a partnership interest on or after the 16th day of a month, and sells the entire partnership interest on or before the 15th day of the following month, that partner would not be treated as having been a partner at all for purposes of §1.706-4, even if that partner otherwise is treated as a partner for purposes of other Code and regulations provisions, including section 6031(b) (relating to the partnership's obligation to furnish each partner a Schedule K-1, "Partner's Share of Income, Deductions, Credits, etc.") and §§1.6012-1(b) and 1.6012-2(g) (relating to the obligation of certain foreign persons engaged in a U.S. trade or business to file a return). However, the Treasury Department and the IRS believe that the application of the conventions should not cause persons who are admitted to and exit from a partnership during a single convention period to avoid all allocations under §1.706-4. Accordingly, the final regulations provide that in the case of a partner who becomes a partner during the partnership's taxable year as a result of a variation, and ceases to be a partner as a result of another variation, and under the application of the partnership's conventions both such variations would be deemed to occur at the same time, the variations with respect to that partner's interest will instead be treated as occurring when they actually occurred. Thus, in such a case, the partnership must treat the partner as a partner for the entire portion of its taxable year during which the partner actually owned an interest. However, in recognition of the increased administrative difficultly this exception would have for PTPs, this exception does not apply to PTPs with respect to holders of publicly traded units (as described in §1.7704-1(b) or (c)(1)).

D. Extraordinary items

Section 1.706-4(d)(3) of the 2009 proposed regulations required a partnership using the proration method to allocate extraordinary items among the partners in proportion to their interests at the beginning of the day on which they are taken into account. Section 1.706-4(d)(3) of the 2009 proposed regulations contained a list of nine enumerated extraordinary items. These final regulations continue to provide special rules for the allocation of extraordinary items; in addition, as discussed in this Part 1.D of the preamble, the final regulations expand the application of the extraordinary item rules to cover partnerships using the interim closing method, modify the list of extraordinary items and the timing of extraordinary item inclusions, and add a small item exception.

i. Extraordinary items and the interim closing method

The 2009 proposed regulations did not require partnerships using the interim closing method to separately account for extraordinary items. However, the Treasury Department and the IRS are aware (and commenters pointed out) that partnerships using the interim closing method and either the semi-monthly convention or the monthly convention to account for extraordinary items may achieve inappropriate tax consequences by shifting the tax consequences of extraordinary items to partners that were not partners in the partnership when the partnership incurred the extraordinary item. The Treasury Department and the IRS believe that extraordinary items should generally be taken into account by the partners that were partners at the time the partnership incurred the extraordinary item. Therefore, the final regulations provide that the extraordinary item rules also apply to partnerships using the interim closing method. Thus, the final regulations require the allocation of extraordinary items as an exception to (1) the proration method, which would otherwise ratably allocate the extraordinary items across the segment, and (2) the conventions, which might otherwise inappropriately shift extraordinary items between a transferor and transferee. The final regulations also provide that extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for section 179 expenses).

ii. Timing of extraordinary items

Proposed §1.706-4(d)(3) provided that a partnership must allocate extraordinary items among the partners in proportion to their interests at the beginning of the calendar day on which they are taken into account (beginning of the day rule). One commenter noted that under this rule, if a partnership interest is transferred on a given date and an extraordinary item is recognized by the partnership after the transfer, but still on the transfer date, the 2009 proposed regulations required the item to be allocated to the transferor. This commenter noted that other regulation sections use a "next day rule" (for example, §§1.1502-76(b)(1)(ii)(B) and 1.338-1(d)). According to the commenter, under the next day rule, an item would be treated as occurring at the beginning of the day following the day on which the extraordinary item is taken into account by the partnership. Another commenter expressed concern that the beginning of the day rule was incompatible with partnership agreements that provide that partners' distributive shares are determined on the basis of hurdles, waterfalls, or other income/loss thresholds.

The Treasury Department and the IRS agree that extraordinary items should generally be allocated according to the partners' interests in the item at the time the extraordinary item arose. However, the Treasury Department and the IRS believe that a "next day" rule could result in inappropriate shifts of extraordinary items between a transferor and a transferee in situations in which the extraordinary items arise before, but on the same day as, the transfer of a partnership interest. In addition, the Treasury Department and the IRS believe that allowing allocation of extraordinary items based upon end of year threshold determinations such as hurdles or waterfalls would be inconsistent with the purpose of the varying interest rule and could result in inappropriate shifts in extraordinary items. Therefore, to avoid inappropriate shifts in extraordinary items, the final regulations provide that extraordinary items must be allocated in accordance with the partners' interests in the partnership item at the time of day that the extraordinary item occurs, regardless of the method and convention otherwise used by the partnership. Thus, if a partner disposes of its entire interest in a partnership before an extraordinary item occurs (but on the same day), the partnership and all of its partners must allocate the extraordinary item in accordance with the partners' interests in the partnership item at the time of day on which the extraordinary item occurred; in such a case, the transferor will not be allocated a portion of the extraordinary item, regardless of when the transfer is deemed to occur under the partnership's convention. However, the final regulations provide that PTPs (as defined in section 7704(b)) may, but are not required to, respect the applicable conventions in determining who held their publicly traded units (as described in §1.7704-1(b) or 1.7704-1(c)(1)) at the time of the occurrence of an extraordinary item. The Treasury Department and the IRS believe that this exception is necessary for administrative convenience given the frequency of variations experienced by PTPs. Examples 1 through 4 of §1.706-4(e)(4) illustrate these timing rules.

As discussed in Part 1.B.i of this preamble, proposed §1.706-4(a)(1) required the partnership and all of its partners to use the same method for all variations in the partners' interests occurring within the partnership's taxable year, whether in complete or partial termination of the partners' interests. Proposed §1.706-4(d)(3) provided that partnerships using the proration method must allocate extraordinary items among the partners in proportion to their interests at the beginning of the calendar day of the day on which they are taken into account, thus prohibiting the partnership from allocating extraordinary items using the proration method. Commenters stated that proposed §1.706-4(a)(1) and (d)(3), when read together, could be interpreted to prohibit partnerships with extraordinary items from the using the proration method. These commenters also stated that these provisions could be interpreted to prohibit the use of the so-called "hybrid method." One commenter explained that under a hybrid method, a partnership separates certain extraordinary items and allocates them to partners based on their interests in the partnership on particular days or periods (for example, the date of sale), effectively using the interim closing method and a calendar day convention with respect to these extraordinary items. According to this commenter, the partnership then allocates the remaining partnership items in accordance with the proration method. A commenter also requested that the final regulations permit partnerships using the proration method to use the interim closing method and a semi-monthly convention to account for extraordinary items. Under the final regulations, a partnership with extraordinary items may use the proration method. As a result, the final regulations effectively permit the hybrid method described by the commenter. However, the final regulations provide that partnerships must allocate extraordinary items according to the partners' interests in the partnership item at the time of day that the extraordinary item arose, generally without regard to the method and convention otherwise used by the partnership.

iii. List of extraordinary items

The 2009 proposed regulations defined an extraordinary item as (i) any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset 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); (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 nonrecourse 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; (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); and (ix) any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included.

The 2009 proposed regulations requested comments on whether any items should be added to or removed from the definition of extraordinary items. After consideration of the comments received, the Treasury Department and the IRS have decided to generally retain the list of enumerated extraordinary items, subject to changes that are discussed in this Part 1.D.iii of the preamble.

a. Two additional extraordinary items and two additional proposed extraordinary items

In response to comments, the final regulations add two items to the extraordinary item list. First, commenters requested that the final regulations provide partnerships with more flexibility in determining what items are extraordinary items. One commenter argued that the definition of extraordinary item should be tied to the uniqueness of the partnership and materiality of the item. Another commenter recommended the final regulations remove the mandatory treatment of the specifically enumerated items as extraordinary items and instead highlight these specific items as items the partnership may agree to treat as extraordinary. In addition, commenters recommended that the final regulations allow the partners to agree to treat other nonenumerated items as extraordinary items. The commenters noted that this could prevent distortion of the economic deal of the partners in certain circumstances. The final regulations adopt the recommendation to allow a partnership to treat additional nonenumerated items as extraordinary items for a taxable year if, for that taxable year, there is an agreement of the partners (as described in Part 1.E of this preamble) to treat consistently such items as extraordinary items. However, this rule does not apply if treating that additional item as an extraordinary item would result in a substantial distortion of income in any partner’s return. Any additional extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for section 179 expenses).

Second, the final regulations provide that an extraordinary item includes any item identified as an additional class of extraordinary item in guidance published in the Internal Revenue Bulletin. The Treasury Department and the IRS believe that this addition is necessary to provide flexibility and guidance in the event that additional classes of items should be treated as extraordinary items.

In addition, proposed regulations under section 706 (REG-109370-10) being published concurrently with these final regulations propose to add two additional extraordinary items. The first proposed additional extraordinary item responds to comments regarding the administrative difficulty PTPs face in satisfying certain withholding obligations if the PTPs are not permitted to use a quarterly convention. As discussed in Part 1.C.iii of this preamble, the final regulations do not permit PTPs to use a quarterly convention. However, the proposed regulations being published concurrently with these final regulations would add an optional extraordinary item for PTPs, which the Treasury Department and the IRS believe is desirable to link each partner's distributive share to the related cash distributions, thereby enabling PTPs and their transfer agents to satisfy their withholding obligations under Chapter 4 of the Code and sections 1441 through 1443 from distributions. Specifically, the proposed regulations provide that, for PTPs, all items of income that are amounts subject to withholding as defined in §1.1441-2(a) (excluding income effectively connected with the conduct of a trade or business within the United States) or withholdable payments under §1.1473-1(a) occurring during a taxable year may be treated as extraordinary items if, for that taxable year, the partners agree to consistently treat all such items as extraordinary items for that taxable year. If the partners so agree, then for purposes of section 706 such items shall be treated as occurring at the next time as of which the recipients of a distribution by the PTP are determined, or, to the extent such income items arise between the final time during the taxable year as of which the recipients of a distribution are determined and the end of the taxable year, such items shall be treated as occurring at the final time during the taxable as of which the recipients of a distribution are determined. This proposed rule does not apply unless the PTP has a regular practice of making at least four distributions (other than de minimis distributions) to its partners during each taxable year. The proposed regulations provide that taxpayers may rely on this proposed additional extraordinary item for PTPs until final regulations are issued.

The second proposed additional extraordinary item addresses partnership deductions attributable to the transfer of partnership equity in connection with the performance of services. Specifically, the proposed regulations being published concurrently with these final regulations would add as an additional extraordinary item any deduction for the transfer of an interest in the partnership in connection with the performance of services and would provide that such deduction is treated as occurring immediately before the transfer or vesting of the partnership interest that results in compensation income for the person who performs the services. Moreover, for such deductions the proposed regulations would “turn off” the exceptions to the extraordinary item rules which would otherwise apply to certain small items and for partnerships for which capital is not a material income-producing factor. The Treasury Department and the IRS believe that this rule is necessary to ensure that, in the case of a transfer of partnership equity in connection with the performance of services, no portion of the deduction for the transfer of a partnership interest in connection with the performance of services will be allocated to the person who performs the services.

b. Clarification of certain enumerated items

This Part 1.D.iii.b provides additional clarification on five of the extraordinary items from the 2009 proposed regulations.

First, the 2009 proposed regulations provided that an extraordinary item includes any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset as defined in section 1221 (determined without the application of any other rules of law). One commenter requested that the final regulations clarify that gains or losses from the actual or deemed sale of securities by securities partnerships (as defined in §1.704-3(e)(3)(iii)) are items resulting from the disposition or abandonment of a capital asset (as defined in section 1221) in the ordinary course of business. Without such a rule, the commenter noted that a securities partnership would incur significant administrative and accounting costs to account for each security bought and sold. The Treasury Department and the IRS believe that it is unnecessary to provide a special rule for securities partnerships; if a securities partnership is engaged in the trade or business of trading securities then it will generally be true that any gains or losses from the actual or deemed sale of securities are items from the disposition of a capital asset in the ordinary course of the partnership's business. Accordingly, the final regulations do not modify this extraordinary item.

Second, commenters inquired as to whether revaluations of partnership property under §1.704-1(b)(2)(iv)(e) or (f) are extraordinary items. Section 1.704-1(b)(2)(iv)(e) generally requires that a partner's capital account be decreased by the fair market value of property distributed by the partnership to such partner. To do so, the partners' capital accounts are adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in the property would be allocated among the partners if there were a taxable disposition of the property for fair market value on the date of distribution. Section 1.704-1(b)(2)(iv)(f) provides that a partnership may increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property on the partnership's books upon the occurrence of certain events. The adjustments to the partners' capital accounts must reflect the manner in which the unrealized income, gain, loss, or deduction inherent in the property would be allocated among the partners if there were a taxable disposition of the property for fair market value on that date. Under §1.704-3(a)(6)(i), section 704(c) principles apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704-1(b)(2)(iv)(f) (reverse section 704(c) allocations). However, partnerships are not generally required to revalue their property on the occurrence of these events. The Treasury Department and the IRS believe that the treatment of an item as an extraordinary item should not depend upon whether the partnership chooses to revalue its assets. Additionally, as discussed in Part 1.F of this preamble, the final regulations generally do not address the interaction of sections 704(b), 704(c), and 706. Accordingly, the final regulations do not include book items from partnership revaluations as extraordinary items.

Third, the 2009 proposed regulations provided that an extraordinary item included any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included. One commenter recommended that the final regulations provide that the Commissioner may only treat a nonenumerated item as an extraordinary item where the Commissioner has provided advance notice by notice or regulation of the types of income subject to scrutiny, or where there is evidence that the proration method was chosen with the intent to substantially distort income. However, the Treasury Department and the IRS believe that such a rule would unduly impede the ability of the IRS to correct substantial distortions of income, and accordingly the final regulations do not adopt this suggestion.

Fourth, the 2009 proposed regulations provided that an extraordinary item included any section 481(a) adjustment. The Treasury Department and the IRS have determined that the inclusion of section 481(a) adjustments within the meaning of “extraordinary items” for purposes of section 706 may be overbroad. The purpose of the extraordinary items rule is to avoid substantial distortions of income among partners by requiring a partnership to allocate certain significant, nonrecurring items incurred other than in the ordinary course of business among its partners in proportion to their ownership interests in the partnership on the date the extraordinary item was incurred. Section 481 requires a taxpayer that has changed its method of accounting to compute its income by taking into account adjustments necessary to prevent any duplication or omission that would otherwise result from the change. Under certain circumstances, these adjustments may be spread over a period of years, and in all circumstances, the adjustments relate to a change of accounting method by the taxpayer rather than a particular item incurred by the taxpayer. Because the new accounting method that triggers the section 481 adjustment applies to the entire taxable year of the change, the adjustment similarly relates to that entire taxable year rather than any specific date within that taxable year. Therefore, the Treasury Department and the IRS believe that not all section 481 adjustments should be treated as extraordinary items. However, in situations in which the change in accounting method is initiated after the occurrence of a variation, the Treasury Department and the IRS believe it is appropriate to allocate any resulting item attributable to the change among the partners in accordance with their percentage interests at and after the time the method change is initiated. Therefore, the final regulations have changed this extraordinary item to include only the effects of any change in accounting method initiated by the filing of the appropriate form after a variation occurs.

Fifth, the 2009 proposed regulations provided that an extraordinary item included:

> 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 nonrecourse 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).

Section 108(e)(8) and (i) generally require that a partnership allocate discharge of indebtedness income (COD income) to the partners that were partners immediately prior to the transaction giving rise to the COD income. Thus, the rules under section 108(e)(8) and (i) and section 706 could provide conflicting results if items of a partnership subject to section 108(e)(1) or 108(i) were treated as an extraordinary item. This could occur where section 108(e)(8) or 108(i) provides a rule regarding the timing of COD income that is different from the extraordinary item timing rules under section 706. Thus, because section 108(e)(8) and (i) already provide special timing rules, the Treasury Department and the IRS believe it is unnecessary to treat these items as extraordinary items. Accordingly, the final regulations provide a limited exception in the definition of extraordinary items in §1.706-4(e)(1)(v) for amounts subject to section 108(e)(8) or 108(i).

iv. Small item exception for extraordinary items

In addition to receiving comments on the items on the extraordinary item list, the Treasury Department and the IRS received many comments requesting that the final regulations provide a de minimis rule for extraordinary items. One commenter suggested that an extraordinary item would be considered de minimis if, for the partnership's taxable year: (i) the total of the particular class of extraordinary items 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 expenses; and (ii) all extraordinary items in total do not exceed $10 million. Another commenter recommended using a dollar amount threshold per item, a cumulative amount (for example, $100,000), or an amount that varies depending on the size of the partnership or whether the partnership is a PTP.

The Treasury Department and the IRS recognize that accounting for extraordinary items can be burdensome to partnerships. Accordingly, the final regulations adopt the recommendation to include a small item exception. Specifically, the final regulations allow a partnership to treat an otherwise extraordinary item as not extraordinary if, for the partnership's taxable year: (1) the total of all items in the particular class of extraordinary items (for example, all tort or similar liabilities) is less than five percent of the partnership's (a) gross income, including tax-exempt income described in section 705(a)(1)(B), 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 (2) the total amount of the extraordinary items from all classes of extraordinary items amounting to less than five percent of the partnership's (a) gross income, including tax-exempt income described in section 705(a)(1)(B), 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, does not exceed $10 million in the taxable year, determined by treating all such extraordinary items as positive amounts. Examples 5 and 6 of §1.706-4(e)(4) illustrate the small item exception.

E. Agreement of the Partners

As discussed in this preamble, the final regulations provide that partnerships may make certain decisions under §1.706-4 by agreement of the partners. See Part 1.B.ii (agreement to perform regular monthly or semi-monthly interim closings), Part 1.B.iv (selection to use the proration method), Part 1.C.i (choice of convention), and Part 1.D.iii.a (adding extraordinary items).

Proposed §1.706-4(a)(1) provided that a partnership may only use the proration method by agreement of the partners. Proposed §1.706-4(c)(3) and -(d)(4) provided examples that indicated that the agreement of the partners to use the proration method must be part of the partnership agreement. Commenters requested clarification on the meaning of "by agreement of the partners" and on whether a partnership may delegate the authority to select the proration method. Another commenter suggested that the final regulations adopt different rules for a variation caused by a transaction between the partnership and one or more partners, and for a variation caused by a transaction between partners. One commenter noted that existing partnerships may not be able to amend the partnership agreement within the timeframe prescribed by section 761(c). Section 1.706-4(f) of the final regulations provides guidance on the meaning of "agreement of the partners."

The Treasury Department and the IRS believe that the final regulations should provide the partners with a voice in the choice of methods, conventions, and additional extraordinary items, and should allow the IRS to easily ascertain what the partnership selected, without unduly burdening the partnership. In response to comments, the Treasury Department and the IRS have determined that each of these objectives can be achieved by allowing partnerships to select their method, convention, or additional extraordinary items through a dated, written statement maintained with the partnership's books and records by the due date, including extensions, of the partnership's tax return. The final regulations provide that such a statement would include, for example, a selection included in the partnership agreement. The final regulations also permit the selection of the method, convention, or additional extraordinary item to be made by a person authorized to make that selection (including under a grant of general authority provided for by either state law or in the partnership agreement), if that person's selection is in a dated, written statement maintained with the partnership's books and records by the due date, including extensions, of the partnership's tax return. That person's selection will be binding on the partnership and the partners.

F. <u>Interaction of sections 706(d) and 704</u>

The 2009 proposed regulations did not address the interaction of section 706(d) with the rules under section 704. Section 1.704-1(b)(1) generally provides that, under section 704(b), if a partnership agreement does not provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, or if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner but such allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). However, §1.704-1(b)(1)(iii) provides that the determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and the regulations thereunder is not conclusive as to the tax treatment of a partner with respect to such distributive share. Section 1.704-1(b)(1)(iii) further provides that an allocation that is respected under section 704(b) and the regulations nevertheless may be reallocated under other provisions, such as section 706(d) (and related assignment of income principles).

The Treasury Department and the IRS received several comments requesting guidance on the interaction of sections 706(d) and 704. One commenter requested clarification on the effect of a reallocation under section 706(d) on the application of provisions of section 704(b), particularly regarding the capital account maintenance provisions in §1.704-1(b)(2)(iv). Another commenter indicated that partnership agreements are drafted 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). This commenter asked that the final regulations address whether section 706(d) applies to the allocation of book items rather than tax items.

The Treasury Department and the IRS have carefully considered the comments relating to the interaction of sections 706(d) and 704 and believe that the issues require further consideration and are generally outside the scope of these final regulations. However, the Treasury Department and the IRS may consider addressing these issues in future guidance.

2. Deemed dispositions

Proposed §1.706-1(c)(2)(iii) provided that a deemed disposition of a partner's interest pursuant to §1.1502-76(b)(2)(vi) (relating to corporate partners that become or cease to be members of a consolidated group within the meaning of §1.1502-1(h)),

§1.1362-3(c)(1) (relating to the termination of the subchapter S election of an S corporation partner), or §1.1377-1(b)(3)(iv) (regarding an election to terminate the taxable year of an S corporation partner) shall be treated as a disposition of the partner's entire interest in the partnership. The preamble to the 2009 proposed regulations indicated that this treatment is solely for purposes of section 706. One commenter explained that unless the regulatory language specifically limits the disposition treatment to section 706, taxpayers could deem these transactions to be dispositions for other purposes of the Code, thereby achieving unintended results. For example, the commenter stated that, unless clarified, the 2009 proposed regulations could cause unintended consequences under sections 708, 743(b), or 1001 when a member of a consolidated group sells an interest in a partnership that exits the consolidated group after the sale. Consistent with the preamble to the 2009 proposed regulations, the final regulations clarify that deemed dispositions under §§1.1502-76(b)(2)(vi), 1.1362-3(c)(1), or 1.1377-1(b)(3)(iv) are treated as a disposition of the partner's entire interest in the partnership solely for purposes of section 706.

Effective/Applicability Dates

With respect to amendments to §§1.706-1 (with the exception of two special rules applicable to §1.706-1(b)(6)(iii)), 1.706-4 (with the exception of a special rule applicable to §1.704-4(c)(3)), and 1.706-5, these final regulations are applicable to partnership taxable years that begin on or after [**INSERT DATE OF PUBLICACTION IN THE FEDERAL REGISTER**].

With respect to the final regulations contained in §1.706-1(b)(6)(iii), the regulations apply to the partnership taxable years that begin on or after [**INSERT DATE**

OF PUBLICACTION IN THE FEDERAL REGISTER], subject to two special rules. First, under the current regulations, partnerships formed prior to September 23, 2002 (existing partnerships) generally are exempt from the rules of §1.706-1(b)(6) unless they have voluntarily chosen to apply them or unless they have undergone a technical termination under section 708(b)(1)(B). The final regulations retain this special rule, such that an existing partnership will not be subject to the modified minority interest rule in §1.706-1(b)(6)(iii) unless there has been such an election or technical termination of the partnership. Second, because the final regulations modify §1.706-1(b)(6)(iii) but otherwise leave the rules of §1.706-1(b)(6) unchanged, it is appropriate to exempt other partnerships from the modified minority interest rule if they are already subject to §1.706-1(b)(6) and the minority interest rule of the current regulations (interim period partnerships). Thus, interim period partnerships will be exempt from the modified minority interest rule of §1.706-1(b)(6)(iii) unless they voluntarily elect to be subject to this rule or undergo a technical termination.

The final regulations under §1.706-4 generally apply for partnership taxable years that begin on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**; however, the rules of §1.706-4(c)(3) do not apply to existing PTPs. For purposes of this effective date provision, an existing PTP is a partnership described in section 7704(b) that was formed prior to April 19, 2009. For purposes of this effective date provision, the termination of a PTP under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits is disregarded in determining whether the PTP is an existing PTP.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these final regulations. It is hereby certified that the collection of information in this Treasury decision will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6). The Treasury Department and the IRS believe that the economic impact on small entities as a result of the collection of information in this Treasury decision will not be significant. The small entities subject to the collection are business entities formed as partnerships that choose to adopt the proration method, the semi-monthly or monthly convention, perform semi-monthly or monthly interim closings, or to add an additional class of extraordinary item, in which case the partnership must keep a written statement with its books and records evidencing the decision or delegation. Thus, the collection only applies if the partnership does not wish to accept the default method, convention, and list of extraordinary items provided in these regulations. Furthermore, the information required to be maintained with the partnership's books and records is simply a short statement evidencing the agreement of the partners. For these reasons, the Treasury Department and the IRS do not believe that the collection of information in this Treasury decision has a significant economic impact.

Pursuant to section 7805(f) of the Code, this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business and no comments were received.

Drafting Information

The principal author of these final regulations is Benjamin H. Weaver, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 2

Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding a new entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.706-4 also issued under 26 U.S.C. 706(d). * * *

Par. 2. Section 1.706-0 is added to read as follows:

§1.706-0 Table of contents.

This section lists the captions contained in the regulations under section 706.

§1.706-1 Taxable years of partner and partnership.
(a) Year in which partnership income is includible.
(b) Taxable year.
(1) Partnership treated as taxpayer.
(2) Partnership's taxable year.
(i) Required taxable year.

(ii) Exceptions.
(3) Least aggregate deferral.
(i) Taxable year that results in the least aggregate deferral of income.
(ii) Determination of the taxable year of a partner or partnership that uses a 52-53 week taxable year.
(iii) Special small item exception.
(iv) Examples.
(4) Measurement of partner's profits and capital interest.
(i) In general.
(ii) Profits interest.
(A) In general.
(B) Percentage share of partnership net income.
(C) Distributive share.
(iii) Capital interest.
(5) Taxable year of a partnership with tax-exempt partners.
(i) Certain tax-exempt partners disregarded.
(ii) Example.
(iii) Effective date.
(6) Certain foreign partners disregarded.
(i) Interests of disregarded foreign partners not taken into account.
(ii) Definition of foreign partner.
(iii) Minority interest rule.
(iv) Example.
(v) Effective date.
(A) Generally.
(B) Voluntary change in taxable year.
(C) Subsequent sale or exchange of interests.
(D) Transition rule.
(7) Adoption of taxable year.
(8) Change in taxable year.
(i) Partnerships.
(A) Approval required.
(B) Short period tax return.
(C) Change in required taxable year.
(ii) Partners.
(9) Retention of taxable year.
(10) Procedures for obtaining approval or making a section 444 election.
(11) Effect on partner elections under section 444.
(i) Election taken into account.
(ii) Effective date.
(c) Closing of partnership year.
(1) General rule.
(2) Disposition of entire interest.
(i) In general.
(ii) Example.
(iii) Deemed dispositions.

(3) Disposition of less than entire interest.
(4) Determination of distributive shares.
(5) Transfer of interest by gift.
(d) Effective/applicability date.

<u>§1.706-2 Certain cash basis items prorated over period to which attributable</u>.
[Reserved]

<u>§1.706-2T Temporary regulations; question and answer under the Tax Reform Act of 1984 (temporary)</u>.

<u>§1.706-3 Items attributable to interest in lower tier partnership prorated over entire taxable year</u>. [Reserved]

<u>§1.706-4 Determination of distributive share when a partner's interest varies</u>.
(a) General rule.
(1) Variations subject to this section.
(2) Coordination with section 706(d)(2) and (3).
(3) Allocation of items subject to this section.
(4) Example.
(b) Exceptions.
(1) Permissible changes among contemporaneous partners.
(2) Safe harbor for partnerships for which capital is not a material income-producing factor.
(3) Special rules for publicly traded partnerships.
(c) Conventions.
(1) In general.
(i) Calendar day convention.
(ii) Semi-monthly convention.
(iii) Monthly convention.
(2) Exceptions.
(3) Permissible conventions for each variation.
(4) Examples.
(d)(1) Optional monthly or semi-monthly closings.
(2) Example.
(e) Extraordinary items.
(1) General principles.
(2) Definition.
(3) Small item exception.
(4) Examples.
(f) Agreement of the partners.
(g) Effective/applicability date.

<u>§1.706-5 Taxable year determination</u>.
(a) In general.
(b) Effective/applicability date.

Par. 3. Section 1.706-1 is amended as follows:

a. The language “this paragraph (a)(1)” in the first sentence of paragraph (a)(2) is removed and the language “paragraph (a)(1) of this section” is added in its place.

b. The language “capital or profits” in the first sentence in paragraph (b)(6)(iii) is removed and the language “capital and profits” is added in its place.

c. Paragraph (b)(6)(v)(A) is revised.

d. The last sentence of paragraph (b)(6)(v)(B) is removed and four new sentences are added in its place.

e. Paragraph (b)(6)(v)(C) is revised.

f. Add a sentence at the end of paragraph (b)(6)(v)(D).

g. Paragraph (c)(2) is revised.

h. Paragraph (c)(3) is removed.

i. Paragraph (c)(4) is redesignated as paragraph (c)(3) and the last sentence of newly designated paragraph (c)(3) is removed.

k. New paragraph (c)(4) is added.

l. Paragraph (d) is revised.

The revisions and additions read as follows:

§1.706-1 Taxable years of partner and partnership.

* * * * *

(b) * * *

(6) * * *

(v) * * *

(A) Generally. The provisions of this paragraph (b)(6) (other than paragraph (b)(6)(iii) of this section) apply to partnership taxable years, other than those of an existing partnership, that begin on or after July 23, 2002. The provisions of paragraph (b)(6)(iii) of this section apply to partnership taxable years, other than those of an existing partnership or an interim period partnership, that begin on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. For partnership taxable years beginning on or after July 23, 2002, and before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, see the provisions of §1.706-1(b)(6)(iii) as contained in the 26 CFR part 1 on **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]**. For purposes of paragraph (b)(6) of this section, an existing partnership is a partnership that was formed prior to September 23, 2002, and an interim period partnership is a partnership that was formed on or after September 23, 2002, and prior to **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(B) * * * An existing partnership that makes such a change prior to **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** will generally cease to be exempted from the requirements of this paragraph (b)(6) of this section, and thus will be subject to the requirements of paragraph (b)(6) of this section, except for paragraph (b)(6)(iii) of this section—instead, such partnership will be subject to the provisions of §1.706-1(b)(6)(iii) as contained in the 26 CFR part 1 on **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]**. An existing partnership that makes such a change on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** will cease to be exempted from the requirements of this paragraph (b)(6). An interim period partnership may change its taxable year to a year determined in accordance with paragraph (b)(6)(iii) of this section. An interim period partnership that makes such a change will cease to be exempted from the requirements of paragraph (b)(6)(iii) of this section.

(C) Subsequent sale or exchange of interests. If an existing partnership or an interim period partnership terminates under section 708(b)(1)(B), the resulting partnership is not an existing partnership or an interim period partnership for purposes of paragraph (b)(6)(v) of this section.

(D) * * * If, in a partnership taxable year beginning on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, an interim period partnership voluntarily changes its taxable year to a year determined in accordance with paragraph (b)(6)(iii) of this section, then the partners of that partnership may apply the provisions of §1.702-3T to take into account all items of income, gain, loss, deduction, and credit attributable to the partnership year of change ratably over a four-year period.

* * * * *

(c) * * *

(2) Disposition of entire interest--(i) In general. A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in the partnership, with respect to a partner whose entire interest in the partnership is liquidated, and with respect to a partner who dies. In the case of a death, liquidation, or sale or exchange of a partner's entire interest in the partnership, the partner shall include in his taxable income for his taxable year within or with which the partner's interest in the partnership ends the partner's distributive share of items described in section 702(a) and any guaranteed payments under section 707(c) for the partnership taxable year ending with the date of such termination. If the decedent partner's estate

or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest shall close on the date of such sale or exchange, or the date of the completion of the liquidation. The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition.

(ii) Example. H is a partner of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 2015. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 2015. Such distribution by the estate is not a sale or exchange of H's partnership interest. The taxable year of the partnership will close with respect to H on March 31, 2015, and H will include in his final return for his final taxable year (January 1, 2015, through March 31, 2015) his distributive share of partnership items for that period under the rules of sections 706(d)(2), 706(d)(3), and §1.706-4. W will include in her return for the taxable year ending December 31, 2015, her distributive share of partnership items for the period of April 1, 2015, through December 31, 2015, under the rules of sections 706(d)(2), 706(d)(3), and §1.706-4.

(iii) Deemed dispositions. A deemed disposition of the partner's interest pursuant to §1.1502-76(b)(2)(vi) (relating to corporate partners that become or cease to be members of a consolidated group within the meaning of §§1.1502-1(h)), 1.1362-3(c)(1) (relating to the termination of the subchapter S election of an S corporation partner), or 1.1377-1(b)(3)(iv) (regarding an election to terminate the taxable year of an S corporation partner), shall be treated as a disposition of the partner's entire interest in the partnership solely for purposes of section 706.

* * * * *

(4) Determination of distributive shares. See section 706(d)(2), 706(d)(3), and §1.706-4 for rules regarding the methods to be used in determining the distributive shares of items described in section 702(a) for partners whose interests in the

partnership vary during the partnership's taxable year as a result of a disposition of a partner's entire interest in a partnership as described in paragraph (c)(2) of this section or as a result of a disposition of less than a partner's entire interest as described in paragraph (c)(3) of this section.

* * * * *

(d) Effective/applicability date. (1) The rules for paragraphs (a) and (b) of this section apply for partnership taxable years ending on or after May 17, 2002, except for paragraphs (b)(5) and (6) of this section, which generally apply to partnership taxable years beginning on or after July 23, 2002 (however, see paragraphs (b)(5)(iii) and (b)(6)(v) of this section for certain exceptions to and transition relief from the applicability dates of paragraphs (b)(5) and (6) of this section).

(2) The rules for paragraph (c)(1) of this section apply for partnership taxable years beginning after December 31, 1953. All other paragraphs under paragraph (c) of this section apply for partnership taxable years that begin on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Par. 4. Add reserved § 1.706-2 with the following heading:

§1.706-2 Certain cash basis items allocable. [Reserved]

Par. 5. Add reserved § 1.706-3 with the following heading:

§1.706-3 Items attributable to interest in lower tier partnership prorated over entire taxable year. [Reserved]

Par. 6. Section 1.706-4 is added to read as follows:

§1.706-4 Determination of distributive share when a partner's interest varies.

(a) General rule--(1) Variations subject to this section. Except as provided in paragraph (a)(2) of this section, this section provides rules for determining the partners' distributive shares of partnership items when a partner's interest in a partnership varies during the taxable year as a result of the disposition of a partial or entire interest in a partnership as described in §1.706-1(c)(2) and (3), or with respect to a partner whose interest in a partnership is reduced as described in §1.706-1(c)(3), including by the entry of a new partner (collectively, a "variation").

(2) Coordination with sections 706(d)(2) and 706(d)(3) and other Code sections. Items subject to allocation under other rules, including sections 108(e)(8) and 108(i) (which provide special allocation rules for certain items from the discharge or retirement of indebtedness), section 706(d)(2) (relating to the determination of partners' distributive shares of allocable cash basis items) and section 706(d)(3) (relating to the determination of partners' distributive share of any item of an upper tier partnership attributable to a lower tier partnership), are not subject to the rules of this section. In all cases, all partnership items for each taxable year must be allocated among the partners, and no partnership items may be duplicated, regardless of the particular provision of section 706 (or other Code section) which applies, and regardless of the method or convention adopted by the partnership.

(3) Allocation of items subject to this section. In determining the distributive share under section 702(a) of partnership items subject to this section, the partnership shall follow the steps described in this paragraph (a)(3)(i) through (x).

(i) First, determine whether either of the exceptions in paragraph (b) of this section (regarding certain changes among contemporaneous partners and partnerships for which capital is not a material income-producing factor) applies.

(ii) Second, determine which of its items are subject to allocation under the special rules for extraordinary items in paragraph (e) of this section, and allocate those items accordingly.

(iii) Third, determine with respect to each variation whether it will apply the interim closing method or the proration method. Absent an agreement of the partners (within the meaning of paragraph (f) of this section) to use the proration method, the partnership shall use the interim closing method. The partnership may use different methods (interim closing or proration) for different variations within each partnership taxable year; however, the Commissioner may place restrictions on the ability of partnerships to use different methods during the same taxable year in guidance published in the Internal Revenue Bulletin.

(iv) Fourth, determine when each variation is deemed to have occurred under the partnership's selected convention (as described in paragraph (c) of this section).

(v) Fifth, determine whether there is an agreement of the partners (within the meaning of paragraph (f) of this section) to perform regular monthly or semi-monthly interim closings (as described in paragraph (d) of this section). If so, then the partnership will perform an interim closing of its books at the end of each month (in the case of an agreement to perform monthly closings) or at the end and middle of each month (in the case of an agreement to perform semi-monthly closings), regardless of whether any variation occurs. Absent an agreement of the partners to perform regular monthly or semi-monthly interim closings, the only interim closings during the partnership's taxable year will be at the deemed time of the occurrence of variations for which the partnership uses the interim closing method.

(vi) Sixth, determine the partnership's segments, which are specific periods of the partnership's taxable year created by interim closings of the partnership's books. The first segment shall commence with the beginning of the taxable year of the partnership and shall end at the time of the first interim closing. Any additional segment shall commence immediately after the closing of the prior segment and shall end at the time of the next interim closing. However, the last segment of the partnership's taxable year shall end no later than the close of the last day of the partnership's taxable year. If there are no interim closings, the partnership has one segment, which corresponds to its entire taxable year.

(vii) Seventh, apportion the partnership's items for the year among its segments. The partnership shall determine the items of income, gain, loss, deduction, and credit of the partnership for each segment. In general, a partnership shall treat each segment as though the segment were a separate distributive share period. For example, a partnership may compute a capital loss for a segment of a taxable year even though the partnership has a net capital gain for the entire taxable year. For purposes of determining allocations to segments, any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year will be applied based upon the partnership's satisfaction of the limitation or requirement as of the end of the partnership's taxable year. For example, the expenses related to the election to expense a section 179 asset must first be calculated (and limited if applicable) based on the partnership's full taxable year, and then the effect of any limitation must be apportioned among the segments in accordance with the interim closing method or the proration method using any reasonable method.

(viii) Eighth, determine the partnership's proration periods, which are specific portions of a segment created by a variation for which the partnership chooses to apply the proration method. The first proration period in each segment begins at the beginning of the segment, and ends at the time of the first variation within the segment for which the partnership selects the proration method. The next proration period begins immediately after the close of the prior proration period and ends at the time of the next variation for which the partnerships selects the proration method. However, each proration period shall end no later than the close of the segment.

(ix) Ninth, prorate the items of income, gain, loss, deduction, and credit in each segment among the proration periods within the segment.

(x) Tenth, determine the partners' distributive shares of partnership items under section 702(a) by taking into account the partners' interests in such items during each segment and proration period.

(4) Example. (i) At the beginning of 2015, PRS, a calendar year partnership, has three equal partners, A, B, and C. On April 16, 2015, A sells 50% of its interest in PRS to new partner D. On August 6, 2015, B sells 50% of its interest in PRS to new partner E. During 2015, PRS earned \$75,000 of ordinary income, incurred \$33,000 of ordinary deductions, earned \$12,000 of capital gain in the ordinary course of its business, and sustained \$9,000 of capital loss in the ordinary course of its business. Within that year, PRS earned \$60,000 of ordinary income, incurred \$24,000 of ordinary deductions, earned \$12,000 of capital gain, and sustained \$6,000 of capital loss between January 1, 2015, and July 31, 2015, and PRS earned \$15,000 of gross ordinary income, incurred \$9,000 of gross ordinary deductions, and sustained \$3,000 of capital loss between August 1, 2015, and December 31, 2015. None of PRS's items are extraordinary items within the meaning of paragraph (e)(2) of this section. Capital is a material income-

producing factor for PRS. For 2015, PRS determines the distributive shares of A, B, C, D, and E as follows.

(i) First, PRS determines that none of the exceptions in paragraph (b) of this section apply because capital is a material-income producing factor and no variation is the result of a change in allocations among contemporaneous partners.

(ii) Second, PRS determines that none of its items are extraordinary items subject to allocation under paragraph (e) of this section.

(iii) Third, the partners of PRS agree (within the meaning of paragraph (f) of this section) to apply the proration method to the April 16, 2015, variation, and PRS accepts the default application of the interim closing method to the August 6, 2015, variation.

(iv) Fourth, PRS determines the deemed date of the variations for purposes of this section based upon PRS's selected convention. Because PRS applied the proration method to the April 16, 2015, variation, PRS must use the calendar day convention with respect to the April 16, 2015, variation pursuant to paragraph (c) of this section. Therefore, the variation that resulted from A's sale to D on April 16, 2015, is deemed to occur for purposes of this section at the end of the day on April 16, 2015. Further, the partners of PRS agree (within the meaning of paragraph (f) of this section) to apply the semi-monthly convention to the August 6, 2015, variation. Therefore, the August 6, 2015, variation is deemed to occur at the end of the day on July 31, 2015.

(v) Fifth, the partners of PRS do not agree to perform regular semi-monthly or monthly closings as described in paragraph (d) of this section. Therefore, PRS will have only one interim closing for 2015, occurring at the end of the day on July 31.

(vi) Sixth, PRS determines that it has two segments for 2015. The first segment commences January 1, 2015, and ends at the close of the day on July 31, 2015. The second segment commences at the beginning of the day on August 1, 2015, and ends at the close of the day on December 31, 2015.

(vii) Seventh, PRS determines that during the first segment of its taxable year (beginning January 1, 2015, and ending July 31, 2015), it had \$60,000 of ordinary income, \$24,000 of ordinary deductions, \$12,000 of capital gain, and \$6,000 of capital loss. PRS determines that during the second segment of its taxable year (beginning August 1, 2015, and ending December 31, 2015), it had \$15,000 of gross ordinary income, \$9,000 of gross ordinary deductions, and \$3,000 of capital loss.

(viii) Eighth, PRS determines that it has two proration periods. The first proration period begins January 1, 2015, and ends at the close of the day on April 16, 2015; the second proration period begins April 17, 2015, and ends at the close of the day on July 31, 2015.

(ix) Ninth, PRS prorates its income from the first segment of its taxable year among the two proration periods. Because each proration period has 106 days, PRS allocates 50% of its items from the first segment to each proration period. Thus, each proration period contains $30,000 gross ordinary income, $12,000 gross ordinary deductions, $6,000 capital gain, and $3,000 capital loss.

(x) Tenth, PRS calculates each partner's distributive share. Because A, B, and C were equal partners during the first proration period, each is allocated one-third of the partnership's items attributable to that proration period. Thus, A, B, and C are each allocated $10,000 gross ordinary income, $4,000 gross ordinary deductions, $2,000 capital gain, and $1,000 capital loss for the first proration period. For the second proration period, A and D each had a one-sixth interest in PRS and B and C each had a one-third interest in PRS. Thus, A and D are each allocated $5,000 gross ordinary income, $2,000 gross ordinary deductions, $1,000 capital gain, and $500 capital loss, and B and C are each allocated $10,000 gross ordinary income, $4,000 gross ordinary deductions, $2,000 capital gain, and $1,000 capital loss for the second proration period. For the second segment of PRS's taxable year, A, B, D, and E each had a one-sixth interest in PRS and C had a one-third interest in PRS. Thus, A, B, D, and E are each allocated $2,500 gross ordinary income, $1,500 gross ordinary deductions, and $500 capital loss, and C is allocated $5,000 gross ordinary income, $3,000 gross ordinary deductions, and $1,000 capital loss for the second segment.

(b) Exceptions--(1) Permissible changes among contemporaneous partners. The general rule of paragraph (a)(3) of this section, with respect to the varying interests of a partner described in §1.706-1(c)(3), will not preclude changes in the allocations of the distributive share of items described in section 702(a) among contemporaneous partners for the entire partnership taxable year (or among contemporaneous partners for a segment if the item is entirely attributable to a segment), provided that--

(i) Any variation in a partner's interest is not attributable to a contribution of money or property by a partner to the partnership or a distribution of money or property by the partnership to a partner; and

(ii) The allocations resulting from the modification satisfy the provisions of section 704(b) and the regulations promulgated thereunder.

(2) Safe harbor for partnerships for which capital is not a material income-producing factor. Notwithstanding paragraph (a)(3) of this section, with respect to any taxable year in which there is a change in any partner's interest in a partnership for which capital is not a material income-producing factor, the partnership and such partner may choose to determine the partner's distributive share of partnership income, gain, loss, deduction, and credit using any reasonable method to account for the varying interests of the partners in the partnership during the taxable year provided that the allocations satisfy the provisions of section 704(b).

(c) Conventions--(1) In general. Conventions are rules of administrative convenience that determine when each variation is deemed to occur for purposes of this section. Because the timing of each variation is necessary to determine the partnership's segments and proration periods, which are used to determine the partners' distributive shares, the convention used by the partnership with respect to a variation will generally affect the allocation of partnership items. However, see paragraph (e) of this section for special rules regarding extraordinary items, which generally must be allocated without regard to the partnership's convention. Subject to the limitations set forth in paragraphs (c)(2) and (3) of this section, partnerships may generally choose from the following three conventions:

(i) Calendar day convention. Under the calendar day convention, each variation is deemed to occur for purposes of this section at the end of the day on which the variation occurs.

(ii) Semi-monthly convention. Under the semi-monthly convention, each variation is deemed to occur for purposes of this section either:

(A) In the case of a variation occurring on the 1st through the 15th day of a calendar month, at the end of the last day of the immediately preceding calendar month; or

(B) In the case of a variation occurring on the 16th through the last day of a calendar month, at the end of the 15th calendar day of that month.

(iii) Monthly convention. Under the monthly convention, each variation is deemed to occur for purposes of this section either:

(A) In the case of a variation occurring on the 1st through the 15th day of a calendar month, at the end of the last day of the immediately preceding calendar month; or

(B) In the case of a variation occurring on the 16th through the last day of a calendar month, at the end of the last day of that calendar month.

(2) Exceptions. (i) Notwithstanding paragraph (c)(1) of this section, all variations within a taxable year shall be deemed to occur no earlier than the first day of the partnership's taxable year, and no later than the close of the final day of the partnership's taxable year. Thus, in the case of a calendar year partnership applying either the semi-monthly or monthly convention to a variation occurring on January 1st through January 15th, the variation will be deemed to occur for purposes of this section at the beginning of the day on January 1st.

(ii) In the case of a partner who becomes a partner during the partnership's taxable year as a result of a variation, and ceases to be a partner as a result of another variation, if both such variations would be deemed to occur at the same time under the rules of paragraph (c)(1) of this section, then the variations with respect to that partner's interest will instead be treated as occurring on the dates each variation actually occurred. Thus, the partnership must treat such a partner as a partner for the entire portion of its taxable year during which the partner actually owned an interest. See Example 2 of paragraph (c)(4) of this section. However, this paragraph (c)(2)(ii) does not apply to publicly traded partnerships (as defined in section 7704(b)) that are treated as partnerships with respect to holders of publicly traded units (as described in §1.7704-1(b) or 1.7704-1(c)(1)).

(iii) Notwithstanding paragraph (c)(1)(iii) of this section, a publicly traded partnership (as defined in section 7704(b)) that is treated as a partnership may consistently treat all variations occurring during each month as occurring at the end of the last day of that calendar month if the publicly traded partnership uses the monthly convention for those variations.

(3) Permissible conventions for each variation—(i) Rules applicable to all partnerships. A partnership generally shall use the calendar day convention for each variation; however, for all variations during a taxable year for which the partnership uses the interim closing method, the partnership may instead use the semi-monthly or monthly convention by agreement of the partners (within the meaning of paragraph (f) of this section). The partnership must use the same convention for all variations for which the partnership uses the interim closing method.

(ii) Publicly traded partnerships. A publicly traded partnership (as defined in section 7704(b)) that is treated as a partnership may, by agreement of the partners (within the meaning of paragraph (f) of this section) use any of the calendar day, the semi-monthly, or the monthly conventions with respect to all variations during the taxable year relating to its publicly-traded units (as described in §1.7704-1(b) or (c)(1)), regardless of whether the publicly traded partnership uses the proration method with respect to those variations. A publicly traded partnership must use the same convention for all variations during the taxable year relating to its publicly traded units. A publicly traded partnership must use the calendar day convention with respect to all variations relating to its non-publicly traded units for which the publicly traded partnership uses the proration method.

(4) Examples. The following examples illustrate the principles in this paragraph (c).

Example 1. PRS is a calendar year partnership with four equal partners A, B, C, and D. PRS is not a publicly traded partnership. PRS has the following three variations that occur during its 2015 taxable year: on March 11, A sells its entire interest in PRS to new partner E; on June 12, PRS partially redeems B's interest in PRS with a distribution comprising a partial return of B's capital; on October 21, C sells part of C's interest in PRS to new partner E. These transfers do not result in a termination of PRS under section 708. Pursuant to paragraph (a)(3)(iii) of this section, the partners of PRS agree (within the meaning of paragraph (f) of this section) to use the interim closing method with respect to the variations occurring on March 11 and October 21 and agree to use the proration method with respect to the variation occurring on June 12. Pursuant to paragraph (c)(3) of this section, the partners of PRS may agree (within the meaning of paragraph (f) of this section) to use any of the calendar day, semi-monthly, or monthly conventions with respect to the March 11 and October 21 variations, but must use the same convention for both variations. If the partners of PRS agree to use the calendar day convention, the March 11 and October 21 variations will be deemed to occur for purposes of this section at the end of the day on March 11, 2015, and October 21, 2015, respectively. If the partners of PRS agree to use the semi-monthly convention, the March 11 and October 21 variations will be deemed to occur for purposes of this section at the end of the day on February 28, 2015, and October 15, 2015, respectively. If the partners of PRS agree to use the monthly convention, the March 11 and October 21 variations will be deemed to occur for purposes of this section at the end of the day on February 28, 2015, and October 31, 2015, respectively. Pursuant to paragraph (c)(3) of this section PRS must use the calendar day convention with respect to the June 12 variation; thus, the June 12 variation is deemed to occur for purposes of this section at the end of the day on June 12, 2015.

Example 2. PRS is a calendar year partnership that uses the interim closing method and monthly convention to account for variations during its taxable year. PRS is not a publicly traded partnership. On January 20, 2015, new partner A purchases an interest in PRS from one of PRS's existing partners. On February 14, 2015, A sells its entire interest in PRS. These transfers do not result in a termination of PRS under section 708. Under the rules of paragraph (c)(1)(iii) of this section, the January 20, 2015, variation and the February 14, 2015, variation would both be deemed to occur at the same time: the end of the day on January 31, 2015. Therefore, under the exception in paragraph (c)(2)(ii) of this section, the rules of paragraph (c)(1) of this section do not apply, and instead the January 20, 2015, variation and the February 14 variation are considered to occur on January 20, 2015, and February 14, 2015, respectively. PRS must perform a closing of the books on both January 20, 2015, and February 14, 2015, and allocate A a share of PRS's items attributable to that segment.

(d)(1) Optional regular monthly or semi-monthly interim closings. Under the rules of this section, a partnership is not required to perform an interim closing of its books except at the time of any variation for which the partnership uses the interim closing method (taking into account the applicable convention). However, a partnership may, by agreement of the partners (within the meaning of paragraph (f) of this section) perform regular monthly or semi-monthly interim closings of its books, regardless of whether any variation occurs. Regardless of whether the partners agree to perform these regular interim closings, the partnership must continue to apply the interim closing or proration method to its variations according to the rules of this section.

(2) Example. The following example illustrates the principles in this paragraph (d).

Example. (i) PRS is a calendar year partnership with five equal partners A, B, C, D, and E. PRS has the following two variations that occur during its 2015 taxable year: on August 29, A sells its entire interest in PRS to new partner F; on December 27, PRS completely liquidates B's interest in PRS with a distribution. These variations do not result in a termination of PRS under section 708.

(ii) The partners of PRS agree (within the meaning of paragraph (f) of this section) to use the interim closing method and the semi-monthly convention with respect to the variation occurring on August 29. Thus, the August variation is deemed to occur for purposes of this section at the end of the day on August 15, 2015. The partners of PRS agree (within the meaning of paragraph (f) of this section) to use the proration method with respect to the December 27 variation. Therefore, PRS must use the calendar day convention with respect to the December variation pursuant to paragraph (c) of this section. Thus, the December variation is deemed to occur for purposes of this section at the end of the day on December 27, 2015.

(iii) Pursuant to paragraph (d)(1) of this section, the partners of PRS agree (within the meaning of paragraph (f) of this section) to perform regular monthly interim closings. Therefore, PRS will have twelve interim closings for its 2015 taxable year, one at the end of every month and one at the end of the day on August 15. Therefore, PRS will have thirteen segments for 2015, one corresponding to each month from January through July, one segment from August 1 through August 15, one segment from August 16 through August 31, and one corresponding to each month from September through December. PRS must apportion its items among these segments under the rules of paragraph (a)(3) of this section.

(iv) PRS will have two proration periods for 2015, one from December 1 through December 27, and one from December 28 through December 31. Pursuant to the rules of paragraph (a)(3) of this section, PRS will prorate the items in its December segment among these two proration periods. Therefore, PRS will apportion 27/31 of all items in its December segment to the proration period from December 1 through December 27, and 4/31 of all items in its December segment to the proration period from December 28 through December 31.

(v) Pursuant to the rules of paragraph (a)(3)(x) of this section, PRS determines the partners' distributive shares of partnership items under section 702(a) by taking into account the partners' interests in such items during each of the thirteen segments and two proration periods. Thus, A, B, C, D, and E will each be allocated one-fifth of all items in the following segments: January, February, March, April, May, June, July, and August 1 through August 15. B, C, D, E, and F will each be allocated one-fifth of all items in the following segments: August 16 through August 31, September, October, and November. B, C, D, E, and F will each be allocated one-fifth of all items in the proration period from December 1 through December 27. C, D, E, and F will each be allocated one-quarter of all items in the proration period from December 28 through December 31.

(e) Extraordinary items—(1) General principles. Extraordinary items may not be prorated. The partnership must allocate extraordinary items among the partners in proportion to their interests in the partnership item at the time of day on which the extraordinary item occurred, regardless of the method (interim closing or proration method) and convention (daily, semi-monthly, or monthly) otherwise used by the partnership. These rules require the allocation of extraordinary items as an exception to the proration method, which would otherwise ratably allocate the extraordinary items across the segment, and the conventions, which could otherwise inappropriately shift extraordinary items between a transferor and transferee. However, publicly traded partnerships (as defined in section 7704(b)) that are treated as partnerships may, but are not required to, apply their selected convention in determining who held publicly traded units (as described in §1.7704-1(b) or (c)(1)) at the time of the occurrence of an extraordinary item. Extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for section 179 expenses).

(2) Definition. Except as provided in paragraph (e)(3) of this section, an extraordinary item is:

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

(ii) Any item from the disposition or abandonment (other than in the ordinary course of business) of property used in a trade or 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), (a)(3), (a)(4), or (a)(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);

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

(v) Any item resulting from any change in accounting method initiated by the filing of the appropriate form after a variation occurs;

(vi) Any item from the discharge or retirement of indebtedness (except items subject to section 108(e)(8) or 108(i), which are subject to special allocation rules provided in section 108(e)(8) and 108(i));

(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);

(ix) For all partnerships, any additional item if, the partners agree (within the meaning of paragraph (f) of this section) to consistently treat such item as an extraordinary item for that taxable year; however, this rule does not apply if treating that additional item as an extraordinary item would result in a substantial distortion of income in any partner's return; any additional extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for section 179 expenses);

(x) 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;

(xi) Any item identified as an additional class of extraordinary item in guidance published in the Internal Revenue Bulletin.

(3) Small item exception. A partnership may treat an item described in paragraph (e)(2) of this section as other than an extraordinary item for purposes of this paragraph (e) if, for the partnership's taxable year the total of all items in the particular class of extraordinary items (as enumerated in paragraphs (e)(2)(i) through (xi) of this section, for example, all tort or similar liabilities, but in no event counting an extraordinary item more than once) is less than five percent of the partnership's gross income, including tax-exempt income described in section 705(a)(1)(B), in the case of income or gain items, or gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items; and the total amount of the extraordinary items from all classes of extraordinary items amounting to less than five percent of the partnership's gross income, including tax-exempt income described in section 705(a)(1)(B), in the case of income or gain items, or gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items, does not exceed $10 million in the taxable year, determined by treating all such extraordinary items as positive amounts.

(4) Examples. The following examples illustrate the provisions of this paragraph (e).

Example 1. PRS, a calendar year partnership, uses the proration method and calendar day convention to account for varying interests of the partners. At 3:15 p.m. on December 7, 2015, PRS recognizes an extraordinary item within the meaning of paragraph (e)(2) of this section. On December 12, 2015, A, a partner in PRS, disposes of its entire interest in PRS. PRS does not experience a termination under section 708 during 2015. PRS has no other extraordinary items for the taxable year, the small item exception of paragraph (e)(3) of this section does not apply, the exceptions in paragraph (b) of this section do not apply, and PRS is not a publicly traded partnership.

Pursuant to paragraph (e)(1) of this section, the item of income, gain, loss, deduction, or credit attributable to the extraordinary item will be allocated in accordance with the partners' interests in the extraordinary item at 3:15 p.m. on December 7, 2015. The remaining partnership items of PRS that are subject to this section must be prorated across the partnership's taxable year in accordance with paragraph (a)(3) of this section.

Example 2. Assume the same facts as in Example 1, except that PRS uses the interim closing method and monthly convention to account for varying interests of the partners. Pursuant to paragraph (c)(1)(iii) of this section, the December 12 variation is deemed to have occurred for purposes of this section at the end of the day on November 30, 2015. Thus, A will not generally be allocated any items of PRS attributable to the segment between December 1, 2015, and December 31, 2015; however, pursuant to paragraph (e)(1) of this section, PRS must allocate the item of income, gain, loss, deduction, or credit attributable to the extraordinary item in accordance with the partners' interests in the extraordinary item at the time of day on which the extraordinary item occurred, regardless of the convention used by PRS. Thus, because A was a partner in PRS at 3:15 p.m. on December 7, 2015 (ignoring application of PRS's convention), A must be allocated a share of the extraordinary item.

Example 3. Assume the same facts as in Example 2, except that PRS is a publicly traded partnership (within the meaning of section 7704(b)) and A held a publicly traded unit (as described in §1.7704-1(b) or 1.7704-1(c)(1)) in PRS. Under PRS's monthly convention, the December 12 variation is deemed to have occurred for purposes of this section at the end of the day on November 30, 2015. Pursuant to paragraph (e)(1) of this section, a publicly traded partnership (as defined in section 7704(b)) may choose to respect its conventions in determining who held its publicly traded units (as described in §1.7704-1(b) or §1.7704-1(c)(1)) at the time of the occurrence of an extraordinary item. Therefore, PRS may choose to treat A as not having been a partner in PRS for purposes of this paragraph (e) at the time the extraordinary item arose, and thus PRS may choose not to allocate A any share of the extraordinary item.

Example 4. A and B each own a 15 percent interest in PRS, a partnership that is not a publicly traded partnership and for which capital is a material income-producing factor. At 9:00 a.m. on April 25, 2015, A sells its entire interest in PRS to new partner D. At 3:00 p.m. on April 25, 2015, PRS incurs an extraordinary item (within the meaning of paragraph (e)(2) of this section). At 5:00 p.m. on April 25, 2015, B sells its entire interest in PRS to new partner E. Under paragraph (e)(1) of this section, PRS must allocate the extraordinary item in accordance with the partners' interests at 3:00 p.m. on April 25, 2015. Accordingly, a portion of the extraordinary item will be allocated to each of B and D, but no portion will be allocated to A or E.

Example 5. PRS, a calendar year partnership that is not a publicly traded partnership, has a variation in a partner's interest during 2015 and the exceptions in paragraph (b) of this section do not apply. During 2015 PRS has two extraordinary items: PRS recognizes $8 million of gross income on the sale outside the ordinary course of business of an asset described in paragraph (e)(2)(ii) of this section, and PRS also recognizes $12 million of gross income from a tort settlement as described in paragraph (e)(2)(vii) of this section. PRS's gross income (including the gross income from the extraordinary items) for the taxable year is $200 million. The gain from all items described in paragraph (e)(2)(ii) of this section is less than five percent of PRS's gross income ($8 million gross income from the asset sale divided by $200 million total gross income, or four percent) and all of the extraordinary items of PRS from classes that are less than five percent of PRS's gross income ($8 million), in the aggregate, do not exceed $10 million for the taxable year. Thus, the $8 million gain recognized on the asset sale is considered a small item under paragraph (e)(3) of this section and is therefore excepted from the rules of paragraph (e)(1) of this section. Because the gross income attributable to the tort settlement exceeds five percent of PRS's gross income (six percent), the tort settlement gross income is not considered a small item under paragraph (e)(3) of this section. Therefore, the $12 million gross income attributable to the tort settlement must be allocated according to the rules of paragraph (e)(1) of this section in accordance with PRS's partners' interests in the item at the time of the day that the tort settlement income arose.

Example 6. Assume the same facts as Example 5, except that during the year, PRS also recognizes two additional extraordinary items: $2 million of gross income from the sale of a capital asset described in paragraph (e)(2)(i) of this section, and $1 million of gross income from discharge of indebtedness described in paragraph (e)(2)(vi) of this section. Although the gain from items described in each of paragraphs (e)(2)(i), (e)(2)(ii), and (e)(2)(vi) of this section is each less than five percent of PRS's gross income, the extraordinary items of PRS from classes that are less than five percent of PRS's gross income ($11 million), in the aggregate, exceeds $10 million for the taxable year. Thus, none of the items are considered a small item under paragraph (e)(3) of this section. Therefore, the items attributable to the sale of the capital asset, the sale of the trade or business asset, the discharge of indebtedness income, and the tort settlement must each be allocated according to the rules of paragraph (e)(1) of this section in accordance with PRS's partners' interests in the item at the time of the day that the items arose.

(f) Agreement of the partners. For purposes of paragraphs (a)(3)(iii) (relating to selection of the proration method), (c)(3) (relating to selection of the semi-monthly or monthly convention), (d) (relating to performance of regular monthly or semi-monthly interim closings), and (e)(2)(ix) (relating to selection of additional extraordinary items) of this section, the term agreement of the partners means either an agreement of all the partners to select the method, convention, or extraordinary item in a dated, written statement maintained with the partnership's books and records, including, for example, a selection that is included in the partnership agreement, or a selection of the method, convention, or extraordinary item made by a person authorized to make that selection, including under a grant of general authority provided for by either state law or in the partnership agreement, if that person's selection is in a dated, written statement maintained with the partnership's books and records. In either case, the dated written agreement must be maintained with the partnership's books and records by the due date, including extension, of the partnership's tax return.

(g) Effective/applicability date. Except with respect to paragraph (c)(3) of this section, this section applies for partnership taxable years that begin on or after [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**]. The rules of paragraph (c)(3) of this section apply for taxable years of partnerships other than existing publicly traded partnerships that begin on or after [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**]. For purposes of the immediately preceding sentence, an existing publicly traded partnership is a partnership described in section 7704(b) that was formed prior to April 19, 2009. For purposes of this effective date provision, the termination of a publicly traded partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits is disregarded in determining whether the publicly traded partnership is an existing publicly traded partnership.

Par. 7. Section 1.706-5 is added to read as follows:

§1.706-5 Taxable year determination.

(a) In general. For purposes of §1.706-4, the taxable year of a partnership shall be determined without regard to section 706(c)(2)(A) and its regulations.

(b) Effective/applicability date. This section applies for partnership taxable years that begin on or after [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 9. In §602.101, paragraph (b) is amended by adding the following entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR Part or section where identified and described	Current OMB control no.
* * * * *	
1.706-4(f)……………………………………………………………	1545-0123
* * * * *	

Karen L. Schiller

Acting Deputy Commissioner for Services and Enforcement.

Approved: June 3, 2015

Mark J. Mazur
Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2015-18816 Filed: 7/31/2015 08:45 am; Publication Date: 8/3/2015]