Final, proposed regulations address partnership allocations under 'varying interests' rule

September 30, 2015

In brief

Partners, rather than partnerships, pay tax on the partnership's taxable income. When one or more partners' interests in the partnership change during the tax year (in whole or in part) — e.g., a new partner is admitted midyear or an existing partner is redeemed or sells an interest — the partnership must allocate its tax items to those partners whose interests change to take into account the changes.

Final and proposed regulations under Section 706 published by the IRS on August 3 govern the methods a partnership may use to account for an interest change. The Final Regulations also modify rules controlling how a partnership determines its tax year. (The Final and Proposed Regulations also include special rules for publicly traded partnerships that are beyond the scope of this Insight.)

With some notable exceptions discussed below, the Final Regulations apply to partnership tax years that begin on or after August 3, 2015. The Proposed Regulations generally would apply to partnership tax years beginning on or after the date the applicable final regulations are published.

New filing deadlines

While not part of the regulatory packages, Congress has changed the due date for partnership tax returns to March 15 (or two-and-a-half months after the close of its tax year) from April 15 (or three-and-a-half months after the close of its tax year), effective for tax years beginning after December 31, 2015. A partnership still may obtain a filing extension until September 15 (a six-month extension for calendar-year taxpayers). For more information, see PwC Insight, "Congress approves short-term highway bill with revenue offsets; international tax reform remains an option for long-term bill," July 30, 2015.

In detail

Final Regulations

The Final Regulations primarily adopt the concepts set forth in proposed regulations issued in 2009 (the 2009 Proposed Regulations). Since the Final Regulations generally apply to partnership tax years that begin on or after August 3, 2015, most calendar-year partnerships must apply the Final Regulations to their 2016 tax years and beyond.

Tax year

The tax year of a partnership must be determined as though the partnership were a taxpayer. Reg. sec. 1.706-1 requires partnerships to follow tax year-ends that limit the amount of deferred income to partners. Accordingly, partnerships first must adopt the majority partner's tax year-end; if there are no majority partners, the partnership adopts the tax year-end of principal partners; and if there are no principal partners, the partnership adopts the tax year-end that results in the least aggregate deferral of income.

The determination of the tax year that results in the least aggregate deferral of income generally must be made as of the beginning of the partnership's current tax year unless another day more accurately reflects ownership of the partnership.

Under the general rule for determining the tax year of a partnership in Reg. sec. 1.706-1(b)(6)(i), a foreign partner's interest is disregarded unless the foreign partner is allocated income that is effectively connected with a US trade or business. Reg. sec. 1.706-1(b)(6)(iii) provides an exception to that general rule when regarded partners hold only a minority partnership interest; in that circumstance, a foreign partner's interest would be taken into account under Section 706. A regarded partner is any partner that is not a disregarded foreign partner. A minority interest previously had been defined as each regarded partner holding an interest of less than 10-percent of capital *or* profits, and all regarded partners in aggregate holding interests of less than 20-percent. Significantly, the Final Regulations replace the language 'capital *or* profits' with 'capital *and* profits' for partnerships formed on a prospective basis but exempt partnerships formed prior to the publication of the Final Regulations from this modification.

The effect of this change will be to follow the general rule of disregarding a foreign partner's interests in determining the tax year of a nonexempted partnership unless each regarded partner holds less than a 10-percent interest of capital and less than a 10-percent interest of profits, and all regarded partners hold in aggregate less than a 20-percent interest of each.

Thus, for partnerships formed after August 3, 2015, when a general partner holds a one-percent capital interest and is allocated 20 percent or more of the partnership profits, interests held by foreign partners more often will be disregarded in determining the partnership tax year, thereby increasing the likelihood that the partnership's tax year will align with that of the regarded (domestic) partners. Certain partnerships, like those with large carried interests starting after a preferred return is paid, may be required to change tax years once the partnership begins to allocate profits to the carried interest (Reg. sec. 1.706-1(b)(4)(B)).

Varying interests rule

Partnership tax allocations generally must follow economic allocations. All partnership tax items for each tax year must be allocated among the partners, without duplication, under all circumstances. Reg. sec. 1.706-4 provides rules of administrative convenience for partnerships to follow in determining the partners' distributive share of partnership tax items that apply when a partner's interest in a partnership varies during the tax year as a result of either dispositions or reductions, including by the entry of a new partner.

Updated Reg. sec. 1.706-4(a)(3) contains a 10-step process for making allocations in the case of varying interests. These 10 steps are as follows:

<u>Step 1</u> requires the partnership first to consider whether these regulations apply to the partnership. These rules do not apply to certain items allocable under other Code sections, when a variation is the result of a change in the allocations among contemporaneous partners, or in partnerships in which capital is not a material income-producing factor. The 'contemporaneous partner exception' exists to permit interest shifts among partners who were members of the partnership for the entire tax year so long as such shifts are not attributable to fluctuations in capital accounts of the partners.

The Final Regulations expand the safe harbor exception in the 2009 Proposed Regulations for service partnerships to include 'all partnerships where capital is not a material income-producing factor'; any reasonable method may be used to account for the varying interests of partners in such cases.

<u>Step 2</u> requires a determination of whether any items are extraordinary items under the Final Regulations. Extraordinary items must be allocated in accordance with the partners' interests in the partnership item *at the time of day that they occur*, regardless of the method and convention otherwise used by the partnership. The Final Regulations list 11 extraordinary items, including two types of extraordinary items that were not included in the 2009 Proposed Regulations: (1) items identified by partner agreement if no substantial distortion of income in any partner's return exists, and (2) items identified by the IRS. The Final Regulations also include a de minimis rule allowing a partnership to treat an otherwise extraordinary item as not extraordinary as long as no distortion of income exists.

<u>Step 3</u> permits a partnership to use either the interim closing or proration method for each variation of a partner's interest during the partnership's tax year. Absent an agreement of the partners, the default method for all variations is the interim closing method. The interim closing method involves breaking the

partnership's tax year into 'segments,' or specific periods for each interim closing of the partnership's books, and generally is more accurate but more costly to apply.

Alternatively, the proration method involves creating 'proration periods' but does not mandate a closing of the partnership's books. The Final Regulations provide that, upon agreement of the partners, a partnership may perform regular interim closings of its books on a monthly or semi-monthly basis, regardless of whether any variation occurs. Thus, a partnership could have one or more segments or proration periods within a tax year, depending on the number of variations that exist and the method applied to each.

Step 4 requires partnerships to apply the appropriate convention. Partnerships that apply the proration method to a variation must also apply the calendar-day convention, which deems each variation to occur at the end of the day on which the variation arises. In absence of an agreement of the partners to use a convention, the partnership will be deemed to have chosen the calendar day convention. Partnerships that apply the interim closing method to a variation may apply the calendar-day, monthly, or semi-monthly conventions to each variation. Because the Final Regulations permit partnerships to use both the proration and interim closing methods during a tax year, the rules 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.

The monthly and semi-monthly conventions provide rules that deem variations to occur at points in time based on the actual date of occurrence. For example, under both conventions, in the case of a variation occurring on the 1st through the 15th day of a calendar month, the variation is deemed to occur at the end of the last day of the immediately preceding calendar month. Importantly, the Final Regulations provide that all variations within a partnership's tax year are deemed to occur no earlier than the first day and no later than the close of the final day of the partnership's tax year. Further, the application of the conventions may not cause persons who are admitted to and exit from a partnership during a single convention period to avoid all allocations under Reg. sec. 1.706-4.

Step 5 is to determine whether there is an agreement of the partners to perform regular monthly or semi-monthly interim closings of the books. Step 6 is to determine the partnership's segments, and Step 7 is to apportion the partnership's items for the year among segments. Step 8 is to determine the partnership's proration periods, and Step 9 is to prorate the items of income, gain, loss, deduction, and credit among the proration periods within each segment based on the conventions applied. Step 10 requires partnerships to determine each partner's distributive share of partnership items by taking into account the partners' interests in such items during each segment and proration period.

Proposed Regulations

The IRS also issued, and requested public comment on, Proposed Regulations governing the allocation of cash-basis and tiered-partnership items.

Allocable cash-basis items

Section 706(d)(2) governs the allocation of 'allocable cash basis items' by essentially requiring such items to be pro-rated over the entire period to which they are attributable and then allocated on a daily basis to the partners in proportion to their interests at the close of each day.

The Proposed Regulations seek to limit allocations of partnership deductions to partners admitted after an expense item was incurred, and request comments on a provision that is intended to limit the allocation of any deductions for the transfer of an interest in a partnership in connection with the performance of services to partners other than the person who performed the services.

The Proposed Regulations also would define the term 'allocable cash basis items,' and contain a de minimis exception to the rules of Section 706(d)(2).

Tiered partnership issues

Section 706(d)(3) governs the allocation of items under the varying interests rule flowing from a lower-tier partnership. Specifically, Section 706(d)(3) provides that if an upper-tier partner's interest changes during the tax year, then each upper-tier partner's allocation of an item flowing from a lower-tier partnership must be allocated by determining the appropriate portion of each lower-tier item to the appropriate days in which the upper-tier partnership is a partner and then allocating the upper-tier's portion among its partners in proportion to their interests in the upper-tier partnership at the close of such day.

The Proposed Regulations would provide an exception to Section 706(d)(3) under certain circumstances and request comment on appropriate safe harbors to consider given the potential issues related to the lack of information sharing among tiered partnerships.

The takeaway

The changes affecting the determination of a partnership's tax year will significantly affect reporting for partnerships with foreign partners and large profits interests, such as many investment partnerships. In assessing whether to disregard a foreign partner's interest in determining the partnership's tax year, significant consideration should be given to the date that the determination is made if the carried interest hurdle is not yet overcome.

The Final Regulations, under the varying interests rule, provide detailed guidance on how to allocate items when partners' interests change. They also provide some flexibility by permitting partnerships to control decisions of methods, conventions, and additional extraordinary items. Thus, a partnership must balance competing concerns of costs and administrative burdens when determining which method and conventions it will apply. Finally, the ability to set a specific time of day at which an extraordinary item occurs and the partners of the partnership at that time is very helpful when structuring deals when order matters.

With respect to the new filing deadlines enacted by Congress, a key takeaway is the effect the new March 15 date has on Section 761 and a partnership's ability to amend its agreement. Section 761(c) defines a 'Partnership Agreement' as including any modifications made on or before 'the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions).' Previously, that date was April 15. Now, partnerships will have only until March 15 to make any agreement changes effective for the prior year.

Let's talk

For a deeper discussion of how this may affect your business, please contact:

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