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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-144620-04

RIN 1545-BD70

Partner's Distributive Share

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: The proposed regulations provide rules for testing the substantiality of an allocation under section 704(b) where the partners are look-through entities or members of a consolidated group, provide additional guidance on the effect of other provisions, such as section 482, upon the tax treatment of a partner with respect to the partner's distributive share under section 704(b), and revise the existing rules for determining the partners' interests in a partnership. The proposed regulations affect partnerships and their partners. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by January 25, 2006. Outlines of topics to be discussed at the public hearing scheduled for February 15, 2006, at 10 a.m., must be received by January 25, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-144620-04), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-144620-04), Courier's Desk, Internal Revenue

Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS internet site at http://www.irs.gov/regs or via the Federal eRule making Portal at http://www.regulations.gov(IRS REG-144620-04). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW; Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Timothy J. Leska, (202) 622-3050; concerning submissions and the hearing LaNita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Subchapter K is intended to permit taxpayers to conduct joint business activities through a flexible economic arrangement without incurring an entity-level tax. To achieve this goal of a flexible economic arrangement, partners are generally permitted to decide among themselves how a partnership’s items will be allocated. Section 704(a) of the Internal Revenue Code (Code) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided, be determined by the partnership agreement.

Section 704(b) places a significant limitation on the general flexibility of section 704(a). Specifically, section 704(b) provides that a partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner’s interest in the partnership (determined by taking into account all facts and circumstances) if the allocation to a partner under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect. Thus, the statute provides that partnership allocations either must have substantial economic effect or must be in accordance with the partner's interest in the partnership.

Section 1.704-1(b)(2)(i) provides that the determination of whether an allocation of income, gain, loss, or deduction to a partner has substantial economic effect involves a two-part analysis. First, the allocation must have economic effect within the meaning of §1.704-1(b)(2)(ii). Second, the economic effect of the allocation must be substantial within the meaning of §1.704-1(b)(2)(iii).

For an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that, in the event that there is an economic benefit or burden that corresponds to the allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden. §1.704-1(b)(2)(ii)(a). Under §1.704-1(b)(2)(ii)(b), an allocation of income, gain, loss, or deduction (or item thereof) to a partner generally has economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides: (1) for the determination and maintenance of the partners' capital accounts in accordance with §1.704-1(b)(2)(iv); (2) for liquidating distributions to the partners to be made in accordance with the positive capital account balances of the partners; and (3) for each partner to be unconditionally obligated to restore the deficit balance in the partner's capital account following the liquidation of the partner's partnership interest. In lieu of satisfying the third requirement, the partnership may satisfy the qualified income offset rules set forth in

§1.704-1(b)(2)(ii)(d). An allocation also may be deemed to have economic effect if it satisfies the economic effect equivalence rules of §1.704-1(b)(2)(ii)(i).

Section 1.704-1(b)(2)(iii)(a) provides as a general rule that the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the previous sentence, the economic effect of the allocation (or allocations) is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account.

If the partnership agreement provides for an allocation of income, gain, loss, deduction or credit to a partner that does not have substantial economic effect, then the partner's distributive share of that item is determined in accordance with the partner's interest in the partnership. References in section 704(b) or §1.704-1 to a partner's interest in the partnership, or to the partners' interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated, taking into account all facts and circumstances relating to the economic arrangement of the partners.

Section 1.704-1(b)(3)(i) provides that all partners' interests are presumed to be equal (determined on a per capita basis). However, this presumption may be rebutted by the taxpayer or the IRS by establishing facts and circumstances that show that the partners' interests in the partnership are otherwise.

Section 1.704-1(b)(1)(iii) provides that an allocation that is respected under section 704(b) nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and §1.751-1(b)(2)(ii).

On April 21, 2004, temporary regulations (TD 9121) relating to the proper allocation of partnership expenditures for foreign taxes were published in the **Federal Register** (69 FR 21405). In the preamble to those regulations, the IRS and the Treasury Department indicated a concern that some partnerships are taking the position that, in determining if the economic effect of a partnership allocation is substantial, they need not consider the tax consequences to an owner of the partner that result from the allocation. This position is inconsistent with the policies underlying the substantial economic effect rules, because it would allow a partnership to make tax-advantaged allocations if the tax advantages of the allocations accrue to an owner of a partner, rather than to the partner itself.

Explanation of Provisions

These proposed regulations provide that the interaction of a partnership allocation with the tax attributes of owners of look-through entities must be taken into account when testing the substantiality of the allocation to a partner that is a look-through entity. For this purpose, look-through entities include partnerships, S corporations, trusts, certain controlled foreign corporations, and entities that are disregarded for federal tax purposes, such as qualified subchapter S subsidiaries under section 1361(b)(3), entities that are disregarded under §§301.7701-1 through 301.7701-3 of the Procedure and Administration Regulations, or qualified real estate investment trusts (REIT) subsidiaries within the meaning of section 856(i)(2). In general, look-through entities are entities that flow certain tax consequences through to their owners. Although regulated investment companies (RICs) and REITs have certain flow through characteristics, the regulations do not include them in the list of look-through entities, because the Treasury Department and the IRS believe that the burdens of a rule requiring taxpayers to look through these entities in determining the substantiality of partnership allocations generally would outweigh the benefits of such a rule. However, if necessary, RICs and REITs or other look-through entities may be added to the list of look-through entities in future guidance. Comments are requested regarding the treatment of controlled foreign corporations as look-through partners for purposes of §1.704-1(b)(2)(iii)(a)(2) of these proposed regulations.

Specifically, comments are requested concerning whether the rule should be limited to those situations in which the controlled foreign corporation owns greater than a threshold minimum percentage interest in the partnership, or only by taking into account the tax attributes of those U.S. shareholders of the controlled foreign corporation owning above a threshold percentage of the stock of the controlled foreign corporation.

The regulations also provide that the interaction of a partnership allocation with the tax attributes of the consolidated group must be taken into account when testing the substantiality of the allocation to a partner that is a member of a consolidated group. A member of a consolidated group is a member of a group filing (or required to file) consolidated returns for the tax year. See §1.1502-1(h).

The proposed regulations clarify that for purposes of §1.704-1(b)(2)(iii)(a)(1), the after-tax economic consequences of a partner resulting from an allocation or allocations must be compared to the after-tax economic consequences to that partner if the allocation or allocations were made in accordance with the partners' interests in the partnership. The proposed regulations also remove the per capita presumption in §1.704-1(b)(3)(i), which reaches the correct result in very few cases. Finally, the regulations include an example illustrating a fact pattern to which, apart from the application of section 704(b), other sections may apply.

Proposed Effective Date

These regulations are generally proposed to apply for partnership taxable years beginning on or after the date on which final regulations are published in the **Federal**

Register. No inference is intended as to the tax consequences of partnership allocations made in taxable years beginning before the effective date of these regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. 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 regulations, and because the regulation does not impose a collection of information on small entitles, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 15, 2006, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments by January 25, 2006, and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by January 25, 2006. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of this regulation is Timothy J. Leska, Office of the Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the IRS and Treasury Department participated in its development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.704-1 is amended as follows:

1. Paragraph (b)(1)(ii)(a) is amended by adding a sentence at the end of the paragraph.

2. Paragraph (b)(1)(iii) is amended by revising the first three sentences and adding a new fourth sentence.

3. Paragraphs (b)(2)(iii)(a), is redesignated as paragraph (b)(2)(iii)(a)(1) and revised.

4. New paragraph (b)(2)(iii)(a)(2) is added.

5. The last two sentences of paragraph (b)(3)(i) are removed.

6. Paragraph (b)(5) Example 29 and Example 30 are added.

The additions and revisions read as follows:

§1.704-1 Partner's distributive share.

* * * * *

(b) * * *

(1) * * *

(ii) Effective dates. (a) * * * Paragraph (b)(2)(iii)(a)(2) and paragraph (b)(5) Example 30 of this section apply to taxable years beginning on or after the date on which final regulations are published in the **Federal Register**.

(iii) Effect of other sections. The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph (b) is not conclusive as to the tax treatment of a partner with respect to such distributive share. For example, an allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph (b) may not be deductible by such partner if the partner lacks the requisite motive for economic gain (see, e.g., Goldstein v. Commissioner, 364 F.2d 734 (2d. Cir. 1966)), or may be disallowed for that taxable year (and held in suspense) if the limitations of section 465 or section 704(d) are applicable. Similarly, an allocation that is respected under section 704(b) and this paragraph (b) nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and §1.751-1(b)(2)(ii). See paragraph (b)(5) Example 29 of this section. ***

(2) * * *

(iii) Substantiality--(a) In general--(1) Fundamental principles. Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement (and, thus, the allocation or allocations were allocated among the partners in accordance with the partners' interests in the partnership), and there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement (and, thus, the allocation or allocations were allocated among the partners in accordance with the partners' interests in the partnership). In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account. See paragraph (b)(5) Examples 5 and 9 of this section. The economic effect of an allocation is not substantial in the two situations described in paragraphs (b)(2)(iii)(b) and (c) of this section. However, even if an allocation is not described therein, its economic effect may be insubstantial under the general rules stated in this paragraph (b)(2)(iii)(a). References in this paragraph (b)(2)(iii) to allocations include capital account adjustments made pursuant to paragraph (b)(2)(iv)(k) of this section.

(2) Partners that are look-through entities or members of a consolidated group-- (i) Rule. For purposes of this paragraph (b)(2)(iii), in determining the after-tax economic benefit or detriment to any partner that is a look-through entity, the tax consequences that result from the interaction of the allocation with the tax attributes of any person that owns an interest in such a partner, whether directly or indirectly through one or more look-through entities, must be taken into account, and, in determining the after-tax economic benefit or detriment to any partner that is a member of a consolidated group (within the meaning of §1.1502-1(h)), the tax consequences that result from the interaction of the allocation with

the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. See paragraph (b)(5) Example 30 of this section.

(ii) Definition. For purposes of this paragraph (b)(2)(iii)(a)(2), a look-through entity means--

(A) A partnership;

(B) A subchapter S corporation;

(C) A trust;

(D) An entity that is disregarded for Federal tax purposes, such as a qualified subchapter S subsidiary under section 1361(b)(3), an entity that is disregarded as an entity separate from its owner under §§301.7701-1 through 301.7701-3 of this chapter, or a qualified REIT subsidiary within the meaning of section 856(i)(2).

(E) A controlled foreign corporation, as defined in section 957(a), but only with respect to allocations of items of income, gain, loss, or deduction that enter into the corporation's computation of subpart F income or would enter into that computation if such items were allocated to the corporation (collectively, subpart F items). For purposes of this paragraph (b)(2)(iii)(a)(2)(ii)(E), the rule in paragraph (b)(2)(iii)(a)(2)(i) of this section shall apply only by taking into account the tax attributes of a person that is a United States shareholder of the controlled foreign corporation the amount of whose inclusions of gross income under section 951(a) are affected by the partnership's allocations of subpart F items (or would be affected if such items were allocated to the corporation).

* * * * *

(5) Examples. * * *

Example 29. (i) B, a domestic corporation, and C, a controlled foreign corporation, form BC, a partnership organized under the laws of country X. B and C each contribute 50 percent of the capital of BC. B and C are wholly-owned subsidiaries of A, a domestic corporation. Substantially all of BC's income would not be subpart F income if earned directly by C. The BC partnership agreement provides that, for the first fifteen years, BC's gross income will be allocated 10 percent to B and 90 percent to C, and BC's deductions and losses will be allocated 90 percent to B and 10 percent to C. The partnership agreement also provides that, after the initial fifteen year period, BC's gross income will be allocated 90 percent to B and 10 percent to C, and BC's deductions and losses will be allocated 10 percent to B and 90 percent to C.

(ii) Apart from the application of section 704(b), the Commissioner may reallocate or otherwise not respect the allocations under other sections. See paragraph (b)(1)(iii) of this section. For example, BC's allocations of gross income, deductions, and losses may be evaluated and reallocated (or not respected), as appropriate, if it is determined that the allocations result in the evasion of tax or do not clearly reflect income under section 482.

Example 30. PRS is a partnership with three partners, A, B, and C. A is a corporation that is a member of a consolidated group within the meaning of §1.1502-1(h). B is a subchapter S corporation that is wholly owned by D, an individual. C is a partnership with two partners, E, an individual, and F, a corporation that is member of a consolidated group within the meaning of §1.1502-1(h). For purposes of paragraph (b)(2)(iii) of this section, in determining the after-tax economic benefit or detriment of an allocation to A, the tax consequences that result from the interaction of the allocation to A with the tax attributes of the consolidated group in which A is a member must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to B, the tax consequences that result from the interaction of the allocation with the tax attributes of D must be taken into account. In determining the after-tax economic benefit or detriment of an allocation to C, the tax consequences that result from the interaction of the allocation with the tax attributes of E and the consolidated group in which F is a member must be taken into account.

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement.