

involving a partnership that occur on or after December 29, 1994.

(h) *Scope and application.* This section applies solely with respect to taxes under subtitle A of the Internal Revenue Code, and for purposes of this section, any reference to a federal tax is limited to any tax imposed under subtitle A of the Internal Revenue Code.

(i) *Application of nonstatutory principles and other statutory authorities.* The Commissioner can continue to assert and to rely upon applicable non-statutory principles and other statutory and regulatory authorities to challenge transactions. This section does not limit the applicability of those principles and authorities.

[T.D. 8588, 60 FR 27, Jan. 3, 1995; T.D. 8588, 60 FR 9776, 9777, Feb. 22, 1995, as amended by T.D. 8592, 60 FR 18741, April 13, 1995]

§ 1.702-1 Income and credits of partner.

(a) *General rule.* Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit described in subparagraphs (1) through (9) of this paragraph. (For the taxable year in which a partner includes his distributive share of partnership taxable income, see section 706(a) and § 1.706-1(a). Such distributive share shall be determined as provided in section 704 and § 1.704-1.) Accordingly, in determining his income tax:

(1) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), his distributive share of the combined net amount of such gains and losses of the partnership.

(2) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), his distributive share of the combined net amount of such gains and losses of the partnership.

(3) Each partner shall take into account, as part of his gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), his distributive share of the combined net amount of such gains and losses of the partnership. The partnership shall not combine such items with items set forth in subparagraph (1) or (2) of this paragraph.

(4) Each partner shall take into account, as part of the charitable contributions paid by him, his distributive share of each class of charitable contributions paid by the partnership within the partnership's taxable year. Section 170 determines the extent to which such amount may be allowed as a deduction to the partner. For the definition of the term "charitable contribution", see section 170(c).

(5) Each partner shall take into account, as part of the dividends received by him from domestic corporations, his distributive share of dividends received by the partnership, with respect to which the partner is entitled to a credit under section 34 (for dividends received on or before December 31, 1964), an exclusion under section 116, or a deduction under part VIII, subchapter B, chapter 1 of the Code.

(6) Each partner shall take into account, as part of his taxes described in section 901 which have been paid or accrued to foreign countries or to possessions of the United States, his distributive share of such taxes which have been paid or accrued by the partnership, according to its method of treating such taxes. A partner may elect to treat his total amount of such taxes, including his distributive share of such taxes of the partnership, as a deduction under section 164 or as a credit under section 901, subject to the provisions of sections 901 through 905.

(7) Each partner shall take into account, as part of the partially tax-exempt interest received by him on obligations of the United States or on obligations of instrumentalities of the United States, as described in section 35 or section 242, his distributive share of such partially tax-exempt interest received by the partnership. However, if the partnership elects to amortize

premiums on bonds as provided in section 171, the amount received on such obligations by the partnership shall be reduced by the amortizable bond premium applicable to such obligations as provided in section 171(a)(3).

(8)(i) Each partner shall take into account separately, as part of any class of income, gain, loss, deduction, or credit, his distributive share of the following items: Recoveries of bad debts, prior taxes, and delinquency amounts (section 111); gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); nonbusiness expenses as described in section 212; medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); amounts representing taxes and interest paid to cooperative housing corporations (section 216); intangible drilling and developments costs (section 263(c)); pre-1970 exploration expenditures (section 615); certain mining exploration expenditures (section 617); income, gain, or loss to the partnership under section 751(b); and any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement which differs from the allocation of partnership taxable income or loss generally.

(ii) Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately. Thus, if any partner is a controlled foreign corporation, as defined in section 957, items of income that would be gross subpart F income if separately taken into account by the controlled foreign corporation must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country who may exclude from gross income the part of the partner's distributive share which qualifies as earned income, as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Simi-

larly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 183 (relating to activities not engaged in for profit) and the recomputation of tax thereunder for any partner. This paragraph (a)(8)(ii) applies to taxable years beginning on or after July 23, 2002.

(iii) Each partner shall aggregate the amount of his separate deductions or exclusions and his distributive share of partnership deductions or exclusions separately stated in determining the amount allowable to him of any deduction or exclusion under subtitle A of the Code as to which a limitation is imposed. For example, partner A has individual domestic exploration expenditures of \$300,000. He is also a member of the AB partnership which in 1971 in its first year of operation has foreign exploration expenditures of \$400,000. A's distributable share of this item is \$200,000. However, the total amount of his distributable share that A can deduct as exploration expenditures under section 617(a) is limited to \$100,000 in view of the limitation provided in section 617(h). Therefore, the excess of \$100,000 (\$200,000 minus \$100,000) is not deductible by A.

(9) Each partner shall also take into account separately his distributive share of the taxable income or loss of the partnership, exclusive of items requiring separate computations under subparagraphs (1) through (8) of this paragraph. For limitation on allowance of a partner's distributive share of partnership losses, see section 704(d) and paragraph (d) of § 1.704-1.

(b) *Character of items constituting distributive share.* The character in the hands of a partner of any item of income, gain, loss, deduction, or credit described in section 702(a)(1) through (8) shall be determined as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership. For example, a partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner.

Similarly, a partner's distributive share of partnership "hobby losses" (section 270) or his distributive share of partnership charitable contributions to organizations qualifying under section 170(b)(1)(A) retains such character in the hands of the partner.

(c) *Gross income of a partner.* (1) Where it is necessary to determine the amount or character of the gross income of a partner, his gross income shall include the partner's distributive share of the gross income of the partnership, that is, the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss (including items described in section 702(a)(1) through (8)). For example, a partner is required to include his distributive share of partnership gross income:

(i) In computing his gross income for the purpose of determining the necessity of filing a return (section 6012 (a));

(ii) In determining the application of the provisions permitting the spreading of income for services rendered over a 36-month period (section 1301, as in effect for taxable years beginning before January 1, 1964);

(iii) In computing the amount of gross income received from sources within possessions of the United States (section 931);

(iv) In determining a partner's "gross income from farming" (sections 175 and 6073); and

(v) In determining whether the de minimis or full inclusion rules of section 954(b)(3) apply.

(2) In determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a partner's gross income includes his distributive share of partnership gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of partnership gross income from which was derived the partner's distributive share of any item of partnership income, gain, loss, deduction, or credit (as included or disclosed in the partner's return) is considered as an amount of gross income stated in the partner's return for the purposes of section 6501(e). For example, A, who is

entitled to one-fourth of the profits of the ABCD partnership, which has \$10,000 gross income and \$2,000 taxable income, reports only \$300 as his distributive share of partnership profits. A should have shown \$500 as his distributive share of profits, which amount was derived from \$2,500 of partnership gross income. However, since A included only \$300 on his return without explaining in the return the difference of \$200, he is regarded as having stated in his return only \$1,500 (\$300/\$500 of \$2,500) as gross income from the partnership.

(d) *Partners in community property States.* If separate returns are made by a husband and wife domiciled in a community property State, and only one spouse is a member of the partnership, the part of his or her distributive share of any item or items listed in paragraph (a) (1) through (9) of this section which is community property, or which is derived from community property, should be reported by the husband and wife in equal proportions.

(e) *Special rules on requirement to separately state meal, travel, and entertainment expenses.* Each partner shall take into account separately his or her distributive share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1987, and ending with or within partner's taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274 (1) (2), each partner shall take into account separately his or her distributive share of rents paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1989, and ending with or within partners' taxable years beginning on or after January 1, 1987.

(f) *Cross—references.* For special rules in accordance with the principles of section 702 applicable solely for the purpose of the tax imposed by section 56 (relating to the minimum tax for tax preferences) see §1.58-2(a). In the case of a disposition of an oil or gas property by the partnership, see the rules

contained in section 613A(c)(7)(D) and § 1.613A-3(e).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8097, Aug. 15, 1962; T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 6885, 31 FR 7803, June 2, 1966; T.D. 7192, 37 FR 12949, June 30, 1972; T.D. 7564, 43 FR 40496, Sept. 12, 1978; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8247, 54 FR 13680, Apr. 5, 1989; T.D. 8348, 56 FR 21952, May 13, 1991; 57 FR 4913, Feb. 10, 1992; T.D. 9008, 67 FR 48023, July 23, 2002]

§ 1.702-2 Net operating loss deduction of partner.

For the purpose of determining a net operating loss deduction under section 172, a partner shall take into account his distributive share of items of income, gain, loss, deduction, or credit of the partnership. The character of any such item shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. See section 702(b) and paragraph (b) of § 1.702-1. To the extent necessary to determine the allowance under section 172(d)(4) of the nonbusiness deductions of a partner (arising from both partnership and nonpartnership sources), the partner shall separately take into account his distributive share of the deductions of the partnership which are not attributable to a trade or business and combine such amount with his nonbusiness deductions from nonpartnership sources. Such partner shall also separately take into account his distributive share of the gross income of the partnership not derived from a trade or business and combine such amount with his nonbusiness income from nonpartnership sources. See section 172 and the regulations thereunder.

§ 1.702-3T 4-Year spread (temporary).

(a) *Applicability.* This section applies to a partner in a partnership if—

(1) The partnership is required by section 806 of the Tax Reform Act of 1986 (the 1986 Act), Pub. L. 99-514, 100 Stat. 2362, to change its taxable year for the first taxable year beginning after December 31, 1986 (partnership's year of change); and

(2) As a result of such change in taxable year, items from more than one

taxable year of the partnership would, but for the provisions of this section, be included in the taxable year of the partner with or within which the partnership's year of change ends.

(b) *Partner's treatment of items from the partnership's year of change—*(1) *In general.* Except as provided in paragraph (c) of this section, if a partner's share of "income items" exceeds the partner's share of "expense items," the partner's share of each and every income and expense item shall be taken into account ratably (and retain its character) over the partner's first 4 taxable years beginning with the partner's taxable year with or within which the partnership's year of change ends.

(2) *Definitions—*(i) *Income items.* For purposes of this section, the term *income items* means the sum of—

(A) The partner's distributive share of taxable income (exclusive of separately stated items) from the partnership's year of change,

(B) The partner's distributive share of all separately stated income or gain items from the partnership's year of change, and

(C) Any amount includible in the partner's income under section 707(c) on account of payments during the partnership's year of change.

(ii) *Expense items.* For purposes of this section, the term *expense items* means the sum of—

(A) The partner's distributive share of taxable loss (exclusive of separately stated items) from the partnership's year of change, and

(B) The partner's distributive share of all separately stated items of loss or deduction from the partnership's year of change.

(c) *Electing out of 4-year spread.* A partner may elect out of the rules of paragraph (b) of this section by meeting the requirements of § 301.9100-7T of this chapter (temporary regulations relating to elections under the Tax Reform Act of 1986).

(d) *Special rules for a partner that is a partnership or S corporation—*(1) *In general.* Except as provided in paragraph (d)(2) of this section, a partner that is a partnership or S corporation may, if otherwise eligible, use the 4-year