

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

spread (with respect to partnership interests owned by the partner) described in this section.

(2) *Certain partners prohibited from using 4-year spread*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, a partner that is a partnership or S corporation may not use the 4-year spread (with respect to partnership interests owned by the partner) if such partner is also changing its taxable year pursuant to section 806 of the 1986 Act.

(ii) *Exception.* If a partner's year of change does not include any income or expense items with respect to the partnership's year of change, such partner may, if otherwise eligible, use the 4-year spread (with respect to such partnership interest) described in this section even though the partner is a partnership or S corporation. See examples 13 and 14 in paragraph (h) of this section.

(e) *Basis of partner's interest.* The basis of a partner's interest in a partnership shall be determined as if the partner elected not to spread the partnership items over 4 years, regardless of whether such election was in fact made. Thus, for example, if a partner is eligible for the 4-year spread and does not elect out of the 4-year spread pursuant to paragraph (c) of this section, the partner's basis in the partnership interest will be increased in the first year of the 4-year spread period by an amount equal to the excess of the income items over the expense items. However, the partner's basis will not be increased again, with respect to the unamortized income and expense items, as they are amortized over the 4-year spread period.

(f) *Effect on other provisions of the Code.* Except as provided in paragraph (e) of this section, determinations with respect to a partner, for purposes of other provisions of the Code, must be made with regard to the manner in which partnership items are taken into account under the rules of this section. Thus, for example, a partner who does not elect out of the 4-year spread must take into account, for purposes of determining net earnings from self-employment under section 1402(a) for a taxable year, only the ratable portion

of partnership items for that taxable year.

(g) *Treatment of dispositions*—(1) *In general.* If a partnership interest is disposed of before the last taxable year in the 4-year spread period, unamortized income and expense items that are attributable to the interest disposed of and that would be taken into account by the partner for subsequent taxable years in the 4-year spread period shall be taken into account by the partner as determined under paragraph (g)(2) of this section. For purposes of this section, the term *disposed of* means any transfer, including (but not limited to) transfers by sale, exchange, gift, and by reason of death.

(2) *Year unamortized items taken into account*—(i) *In general.* If, at the end of a partner's taxable year, the fraction determined under paragraph (g)(2)(ii) of this section is—

(A) Greater than $\frac{2}{3}$, the partner must continue to take the unamortized income and expense items into account ratably over the 4-year spread period;

(B) Greater than $\frac{1}{3}$ but less than or equal to $\frac{2}{3}$, the partner must, in addition to its ratable amortization, take into account in such year 50 percent of the income and expense items that would otherwise be unamortized at the end of such year (however, this paragraph (g)(2)(i)(B) is only applied once with respect to a partner's interest in a particular partnership); or

(C) Less than or equal to $\frac{1}{3}$, the partner must take into account the entire balance of unamortized income and expense items in such year.

(ii) *Determination of fraction.* For purposes of paragraph (g)(2)(i) of this section, the numerator of the fraction is the partner's proportionate interest in the partnership at the end of the partner's taxable year and the denominator is the partner's proportionate interest in the partnership as of the last day of the partnership's year of change.

(h) *Examples.* The provisions of this section may be illustrated by the following examples.

Example 1. Assume that P1, a partnership with a taxable year ending September 30, is required by the 1986 Act to change its taxable year to a calendar year. All of the partners of P1 are individual taxpayers reporting on a calendar year. P1 is required to change

to a calendar year for its taxable year beginning October 1, 1987, and to file a return for the short taxable year ending December 31, 1987. Based on the above facts, the partners of P1 are required to include the items from more than one taxable year of P1 in income for their 1987 taxable year. Thus, under paragraph (b) 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 by such partner in each of the partner's first four taxable years' beginning with the partner's 1987 taxable year, unless such partner elects under paragraph (c) of this section to include all such amounts in his 1987 taxable year.

Example 2. Assume the same facts as in example 1, except P1 is a personal service corporation with all of its employee-owners reporting on a calendar year. Although P1 is required to change to a calendar year for its taxable year beginning October 1, 1987, neither P1 nor its employee-owners obtain the benefits of a 4-year spread. Pursuant to section 806(e)(2)(C) of the 1986 Act, the 4-year spread provision is only applicable to short taxable years of partnerships and S corporations required to change their taxable year under the 1986 Act.

Example 3. Assume the same facts as example 1 and that I is one of the individual partners of P1. Further assume that I's distributive share of P1's taxable income for the short taxable year ended December 31, 1987 (*i.e.*, P1's year of change), is \$10,000. In addition, I has \$8,000 of separately stated expense from P1's year of change. Since I's income items (*i.e.*, \$10,000 of taxable income) exceed I's expense items (*i.e.*, \$8,000 of separately stated expense) attributable to P1's year of change, I is eligible for the 4-year spread provided by this section. If I does not elect out of the 4-year spread, I will recognize \$2,500 of taxable income and \$2,000 of separately stated expense in his 1987 calendar year return. Assuming I does not dispose of his partnership interest in P1 by December 31, 1989, the remaining \$7,500 of taxable income and \$6,000 of separately stated expense will be amortized (and retain its character) over I's next three taxable years (*i.e.*, 1988, 1989 and 1990).

Example 4. Assume the same facts as example 3, except that I disposes of his entire interest in P1 during 1988. Pursuant to paragraph (g) of this section, I would recognize \$7,500 of taxable income and \$6,000 of separately stated expense in his 1988 calendar year return.

Example 5. Assume the same facts as in example 3, except that I disposes of 50 percent of his interest in P1 during 1989. Pursuant to paragraph (g) of this section, I would recognize \$3,750 of taxable income in his 1989 calendar year return (\$2,500 ratable portion for 1989 plus 50 percent of the \$2,500 of income items that would otherwise be unamortized

at the end of 1989). I would also recognize \$3,000 of separately stated expense items in 1989 (\$2,000 ratable portion for 1989 plus 50 percent of the \$2,000 of separately stated expense items that would otherwise be unamortized at the end of 1989).

Example 6. Assume the same facts as in example 1, except that X, a personal service corporation as defined in section 441(i), is a partner of P1. X is a calendar year taxpayer, and thus is not required to change its taxable year under the 1986 Act. The same result occurs as in example 1 (*i.e.*, unless X elects to the contrary, X is required to include one fourth of its share of income and expense items from P1's year of change in the first four taxable years of X beginning with the 1987 taxable year).

Example 7. Assume the same facts as in example 6, except that X is a fiscal year personal service corporation with a taxable year ending September 30. X is required under the 1986 Act to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for its short year ending December 31, 1987. Based on the above facts, X is not required to include the items from more than one taxable year of P1 in any one taxable year of X. Thus, the provisions of this section do not apply to X, and X is required to include the full amount of income and expense items from P1's year of change in X's taxable income for X's short year ending December 31, 1987. Under section 443 of the Code, X is required to annualize the taxable income for its short year ending December 31, 1987.

Example 8. Assume that P2 is a partnership with a taxable year ending September 30. Under the 1986 Act, P2 would have been required to change its taxable year to a calendar year, effective for the taxable year beginning October 1, 1987. However, P2 properly changed its taxable year to a calendar year for the year beginning October 1, 1986, and filed a return for the short period ending December 31, 1986. The provisions of the 1986 Act do not apply to P2 because the short year ending December 31, 1986, was not required by the amendments made by section 806 of the 1986 Act. Thus, the partners of P2 are required to take all items of income and expense for the short taxable year ending December 31, 1986, into account for the taxable year with or within which such short year ends.

Example 9. Assume that P3 is a partnership with a taxable year ending March 31 and I, a calendar year individual, is a partner in P3. Under the 1986 Act, P3 would have been required to change its taxable year to a calendar year. However, under Rev. Proc. 87-32, P3 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987. Thus, P3 is required to change its taxable year under section 806 of the 1986 Act, and I is required to include

items from more than one taxable year of P3 in one of her taxable years. Furthermore, I's share of P3's income items exceeds her share of P3's expense items for the short period April 1, 1987 through June 30, 1987. Accordingly, under this section, unless I elects to the contrary, I is required to take one fourth of her share of items of income and expense from P3's short taxable year ending June 30, 1987 into account for her taxable year ending December 31, 1987.

Example 10. Assume that P4 is a partnership with a taxable year ending March 31. Y, a C corporation, owns a 51 percent interest in the profits and capital of P4. Y reports its income on the basis of a taxable year ending March 31. P4 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987, under Rev. Proc. 87-32. Under the above facts, P4 is not required to change its taxable year because its March 31 taxable year was the taxable year of Y, the partner owning a majority of the partnership's profits and capital. Therefore, the remaining partners of P4 owning 49 percent of the profits and capital are not permitted the 4-year spread of the items of income and expense with respect to the short year, even though they may be required to include their distributive share of P4's items from more than one taxable year in one of their years.

Example 11. Assume that X and Y are C corporations with taxable years ending June 30. Each owns a 50-percent interest in the profits and capital of partnership P5. P5 has a taxable year ending March 31. Assume that P5 cannot establish a business purpose in order to retain a taxable year ending March 31, and thus P5 must change to a June 30 taxable year, the taxable year of its partners. Furthermore, assume that X's share of P5's income items exceeds its share of P5's expense items for P5's short taxable year ending June 30, 1987. Unless X elects out of the 4-year spread, the taxable year ending June 30, 1987, is the first of the four taxable years in which X must take into account its share of the items of income and expense resulting from P5's short taxable year ending June 30, 1987.

Example 12. Assume that I, an individual who reports income on the basis of the calendar year, is a partner in two partnerships, P6 and P7. Both partnerships have a taxable year ending September 30. Neither partnership can establish a business purpose for retaining its taxable year. Consequently, each partnership will change its taxable year to December 31, for the taxable year beginning October 1, 1987. The election to avoid a 4-year spread is made at the partner level; in addition, a partner may make such elections on a partnership-by-partnership basis. Thus, assuming I is eligible to obtain the 4-year spread with respect to income and expense items from partnerships P6 and P7, I may

use the 4-year spread with respect to items from P6, while not using the 4-year spread with respect to items from P7.

Example 13. I, an individual taxpayer using a calendar year, owns an interest in P8, a partnership using a taxable year ending June 30. Furthermore, P8 owns an interest in P9, a partnership with a taxable year ending March 31. Under section 806 of the 1986 Act, P8 will be required to change to a taxable year ending December 31, while P9 will be required to change to a taxable year ending June 30. As a result, P8's year of change will be July 1 through December 31, 1987, while P9's year of change will be from April 1 through June 30, 1987. Since P9's year of change does not end with or within P8's year of change, paragraph (d)(2) of this section does not prevent P8 from obtaining a 4-year spread with respect to its interest in P9.

Example 14. The facts are the same as in example 13, except that P9 has a taxable year ending September 30, and under the 1986 Act P9 is required to change to a taxable year ending December 31. Therefore, P9's year of change will be from October 1, 1987 through December 31, 1987. Although P8's year of change from July 1, 1987 through December 31, 1987 includes two taxable years of P9 (*i.e.*, October 1, 1986 through September 30, 1987 and October 1, 1987 through December 31, 1987), paragraph (d)(2) of this section prohibits P8 from using the 4-year spread with respect to its interest in P9, because P9's year of change ends with or within P8's year of change.

[T.D. 8167, 52 FR 48530, Dec. 23, 1987, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.703-1 Partnership computations.

(a) *Income and deductions.* (1) The taxable income of a partnership shall be computed in the same manner as the taxable income of an individual, except as otherwise provided in this section. A partnership is required to state separately in its return the items described in section 702(a)(1) through (7) and, in addition, to attach to its return a statement setting forth separately those items described in section 702(a)(8) which the partner is required to take into account separately in determining his income tax. See paragraph (a)(8) of § 1.702-1. The partnership is further required to compute and to state separately in its return:

(i) As taxable income under section 702(a)(9), the total of all other items of gross income (not separately stated) over the total of all other allowable deductions (not separately stated), or