

UTP realizes \$180,000 of loss, and A and C in turn each realize \$90,000 of loss.

(d) [Reserved]

(e) *Effective date.* This section applies to gain or loss allocated with respect to sales or exchanges of stock occurring after December 6, 1999.

[T.D. 8986, 67 FR 15114, Mar. 29, 2002]

§ 1.706-1 Taxable years of partner and partner-ship.

(a) *Year in which partnership income is includible.* (1) In computing his taxable income for a taxable year, a partner is required to include his distributive share of partnership items set forth in section 702 for any partnership year ending within or with his taxable year. A partner shall also include in his taxable income for a taxable year “guaranteed payments” under section 707(c) which are made to him in a partnership taxable year ending within or with his taxable year. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A reports his income for a calendar year, while the partnership of which he is a member reports its income for a fiscal year ending May 31. During the partnership taxable year ending May 31, 1956, A received guaranteed payments of \$1,200 for services and for the use of capital. Of this amount, \$700 was received by A between June 1 and December 31, 1955, and the remaining \$500 was received by him between January 1 and May 31, 1956. This entire \$1,200 received by A is includible in his taxable income for the calendar year 1956 (together with his distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 1956).

(2) If a partner receives distributions under section 731 or sells or exchanges all or part of his partnership interest, any gain or loss arising therefrom does not constitute partnership income and is includible in the partner’s gross income for his taxable year in which the payment is made. See sections 451 and 461.

(b) *Adoption or change in taxable year—(1) Partnership taxable year.* (i) The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

(ii) A newly formed partnership may adopt a taxable year which is the same as the taxable year of all its principal

partners (or the same as the taxable year to which all of its principal partners are concurrently changing) without securing prior approval from the Commissioner, or it may adopt a calendar year without securing prior approval from the Commissioner if all its principal partners are not on the same taxable year. In any other case, a newly formed partnership must secure prior approval from the Commissioner for the adoption of a taxable year.

(iii) An existing partnership may not change its taxable year without securing prior approval from the Commissioner, unless all its principal partners have the same taxable year to which the partnership changes, or unless all its principal partners concurrently change to such taxable year.

(2) *Partner’s taxable year.* A partner may not change his taxable year without securing prior approval from the Commissioner. See section 442 and the regulations thereunder.

(3) *Principal partner.* For the purpose of this paragraph, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(4) *Application for approval—(i) Change.* Application for a change in a taxable year shall be filed on Form 1128 with the Commissioner of Internal Revenue, Washington, DC 20224. If the short period involved in the change ends after December 31, 1973, such form shall be filed on or before the 15th day of the second calendar month following the close of such short period; if such short period ends before January 1, 1974, such form shall be filed on or before the last day of the first calendar month following the close of such short period.

(ii) *Adoption.* Where a newly formed partnership is required to secure prior approval from the Commissioner for the adoption of a taxable year, the partnership shall file an application on Form 1128 with the Commissioner on or before the last day of the month following the close of the taxable year to be adopted. The partnership shall modify Form 1128 to the extent necessary to indicate that it is an application for adoption of a taxable year.

(iii) *Business purpose.* Where prior approval is required under this paragraph, the applicant must establish a business purpose to the satisfaction of the Commissioner. For example, partnership AB, which is on a calendar year, is engaged in a business which has a natural business year (the annual accounting period encompassing all related income and expenses) ending on September 30th. The intention of the partnership to make its tax year coincide with such natural business year constitutes a sufficient business purpose.

(5) *Returns*—(i) *Partner.* A partner who changes his taxable year shall make his return for a short period in accordance with section 443, and shall attach to the return a copy of the letter from the Commissioner granting approval for the change of taxable year.

(ii) *Partnership.* (a) A partnership which changes its taxable year shall make its return for a short period in accordance with section 443, but shall not annualize the partnership taxable income. The partnership shall attach to the return either a copy of the letter from the Commissioner granting approval of the change of taxable year, or a statement indicating that the partnership is changing its taxable year to the same taxable year as that of all its principal partners or to the same taxable year as that to which all its principal partners are concurrently changing.

(b) Any newly formed partnership shall file with its first return either:

(1) A copy of the letter from the Commissioner approving the adoption of a partnership taxable year which is not the same as the taxable year of all its principal partners; or

(2) A statement indicating that the taxable year it has adopted is the same as the taxable year of all its principal partners, or that all its principal partners are concurrently changing to the taxable year it has adopted; or

(3) A statement that all its principal partners are not on the same taxable year and that it is adopting a calendar year without prior approval.

(6) *Effective date.* Section 706(b) applies to any partnership which adopts or changes to a taxable year beginning

on or after April 2, 1954, and to any partner who changes to a taxable year beginning on or after that date. For the purpose of applying this provision, section 708 (relating to the continuation of a partnership) applies to any such taxable year. See section 771(b)(1) and paragraph (b)(1) of §1.771-1. If a partnership has changed to or adopted, or if a partner has changed to, a taxable year beginning on or after April 2, 1954, without obtaining prior approval of the Commissioner, and if, under the provisions of this paragraph, prior approval is required for the change or adoption, such annual accounting period will not be accepted as a taxable year until approval thereof is secured. Under these circumstances, an application to change to or adopt the desired taxable year will be considered timely if filed before August 23, 1956.

(7) *Cross-reference to §1.442-2T and §1.442-3T.* For special rules applicable to certain changes in annual accounting period where the short period involved in the change ends in 1986 or 1987, see §1.442-2T. For special rules applicable to certain adoptions and retentions of a taxable year ending in 1986 or 1987, see §1.442-3T.

(c) *Closing of partnership year*—(1) *General rule.* Section 706(c) and this paragraph provide rules governing the closing of partnership years. The closing of a partnership taxable year or a termination of a partnership for Federal income tax purposes is not necessarily governed by the “dissolution”, “liquidation”, etc., of a partnership under State or local law. The taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner’s entire interest in the partnership (as defined in section 761(d)), or the sale or exchange of a partner’s interest in the partnership, except in the case of a termination of a partnership and except as provided in subparagraph (2) of this paragraph. In the case of termination, the partnership taxable year closes for all partners as of the date of termination. See section 708(b) and paragraph (b) of §1.708-1.

(2) *Partner who retires or sells interest in partnership*—(i) *Disposition of entire interest.* A partnership taxable year

shall close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. However, a partnership taxable year with respect to a partner who dies shall not close prior to the end of such partnership taxable year, or the time when such partner's interest (held by his estate or other successor) is liquidated or sold or exchanged, whichever is earlier. See subparagraph (3) of this paragraph.

(ii) *Inclusions in taxable income.* In the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner shall include in his taxable income for his taxable year within or with which his membership in the partnership ends, his distributive share of items described in section 702(a), and any guaranteed payments under section 707(c), for his partnership taxable year ending with the date of such sale, exchange, or liquidation. In order to avoid an interim closing of the partnership books, such partner's distributive share of items described in section 702(a) may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable. Any partner who is the transferee of such partner's interest shall include in his taxable income, as his distributive share of items described in section 702(a) with respect to the acquired interest, the pro rata part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership. The application of this subdivision may be illustrated by the following example:

Example. Assume that a partner selling his partnership interest on June 30, 1955, has an adjusted basis for his interest of \$5,000 on that date; that his pro rata share of partnership income up to June 30 is \$15,000; and that he sells his interest for \$20,000. Under the

provisions of section 706(c)(2), the partnership year with respect to him closes at the time of the sale. The \$15,000 is includible in his income as his distributive share and, under section 705, it increases the basis of his partnership interest to \$20,000, which is also the selling price of his interest. Therefore, no gain is realized on the sale of his partnership interest. The purchaser of this partnership interest shall include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership taxable year.

(3) *Partner who dies.* (i) When a partner dies, the partnership taxable year shall not close with respect to such partner prior to the end of the partnership taxable year. The partnership taxable year shall continue both for the remaining partners and the decedent partner. Where the death of a partner results in the termination of the partnership, the partnership taxable year shall close for all partners on the date of such termination under section 708(b)(1)(A). See also paragraph (b)(1)(i)(b) of §1.708-1 for the continuation of a 2-member partnership under certain circumstances after the death of a partner. However, 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 completion of the liquidation.

(ii) The last return of a decedent partner shall include only his share of partnership taxable income for any partnership taxable year or years ending within or with the last taxable year for such decedent partner (i. e., the year ending with the date of his death). The distributive share of partnership taxable income for a partnership taxable year ending after the decedent's last taxable year is includible in the return of his estate or other successor in interest. If the estate or other successor in interest of a partner continues to share in the profits or losses of the partnership business, the distributive share thereof is includible in the taxable year of the estate or other successor in interest within or with which the taxable year of the partnership ends. See also paragraph (a)(1)(ii) of §1.736-1. Where the estate or

other successor in interest receives distributions, any gain or loss on such distributions is includible in its gross income for its taxable year in which the distribution is made.

(iii) If a partner (or a retiring partner), in accordance with the terms of the partnership agreement, designates a person to succeed to his interest in the partnership after his death, such designated person shall be regarded as a successor in interest of the deceased for purposes of this chapter. Thus, where a partner designates his widow as the successor in interest, her distributive share of income for the taxable year of the partnership ending within or with her taxable year may be included in a joint return in accordance with the provisions of sections 2 and 6013(a) (2) and (3).

(iv) If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then the taxable year of the partnership with respect to such decedent partner shall close upon the date of death. See section 706(c)(2)(A)(i). 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.

(v) To the extent that any part of a distributive share of partnership income of the estate or other successor in interest of a deceased partner is attributable to the decedent for the period ending with the date of his death, such part of the distributive share is income in respect of the decedent under section 691. See section 691 and the regulations thereunder.

(vi) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. B has a taxable year ending December 31 and is a member of partnership ABC, the taxable year of which ends on June 30. B dies on October 31, 1955. His estate (which as a new taxpayer may, under section 441 and the regulations thereunder, adopt any taxable year) adopts a taxable year ending October 31. The return of the decedent for the period January 1 to October 31, 1955, will include only his distributive share of taxable income of the partnership for its tax-

able year ending June 30, 1955. The distributive share of taxable income of the partnership for its taxable year ending June 30, 1956, arising from the interest of the decedent, will be includible in the return of the estate for its taxable year ending October 31, 1956. That part of the distributive share attributable to the decedent for the period ending with the date of his death (July 1 through October 31, 1955) is income in respect of a decedent under section 691.

Example 2. Assume the same facts as in example 1 of this subdivision, except that, prior to B's death, B and D had agreed that, upon B's death, D would purchase B's interest for \$10,000. When B dies on October 31, 1955, the partnership taxable year beginning July 1, 1955, closes with respect to him. Therefore, the return for B's last taxable year (January 1 to October 31, 1955) will include his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955, plus his distributive share of partnership taxable income for the period July 1 to October 31, 1955. See subdivision (iv) of this subparagraph.

Example 3. H is a member 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, 1955. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 1955. Such distribution by the estate is not a sale or exchange of H's partnership interest. No part of the taxable income of the partnership for the taxable year ending December 31, 1955, which is allocable to H, will be included in H's taxable income for his last taxable year (January 1 through March 31, 1955) or in the taxable income of H's estate for the taxable year April 1 through November 30, 1955. The distributive share of partnership taxable income for the full calendar year that is allocable to H will be includible in the taxable income of W for her taxable year ending December 31, 1955, and she may file a joint return under sections 2 and 6013(a)(3). That part of the distributive share attributable to the decedent for the period ending with the date of his death (January 1 through March 31, 1955) is income in respect of a decedent under section 691.

Example 4. M is a member of partnership JKM which operates on a calendar year. M and his wife S file joint returns for calendar years. In accordance with the partnership agreement, M designated S to succeed to his interest in the partnership upon his death. M, who had withdrawn \$10,000 from the partnership before his death, dies on October 20, 1955. S's distributive share of income for the taxable year 1955 is \$15,000 (\$10,000 of which represents the amount withdrawn by M). S shall include \$15,000 in her income, even

though M received \$10,000 of this amount before his death. S may file a joint return with M for the year 1955 under sections 2 and 6013(a). That part of the \$15,000 distributive share attributable to the decedent for the period ending with the date of his death (January 1 through October 20, 1955) is income in respect of a decedent under section 691.

(4) *Disposition of less than entire interest.* If a partner sells or exchanges a part of his interest in a partnership, or if the interest of a partner is reduced, the partnership taxable year shall continue to its normal end. In such case, the partner's distributive share of items which he is required to include in his taxable income under the provisions of section 702(a) shall be determined by taking into account his varying interests in the partnership during the partnership taxable year in which such sale, exchange, or reduction of interest occurred.

(5) *Transfer of interest by gift.* The transfer of a partnership interest by gift does not close the partnership taxable year with respect to the donor. However, the income up to the date of gift attributable to the donor's interest shall be allocated to him under section 704(e)(2).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7286, 38 FR 26912, Sept. 27, 1973; T.D. 8123, 52 FR 3623, Feb. 5, 1987]

§ 1.706-1T Taxable years of certain partnerships (temporary).

(a) *Taxable year determined by reference to the partners—(1) In general.* If for any taxable year a partnership's taxable year cannot be determined by reference to the taxable year of its partners owning a majority interest in partnership profits and capital (as described in section 706(b)(1)(B)(i)) or by reference to the taxable year of all its principal partners (as described in section 706(b)(1)(B)(ii)), then the partnership must determine its taxable year under section 706(b)(1)(B)(iii). Under section 706(b)(1)(B)(iii), the taxable year of the partnership, except as provided in paragraph (b) of this section, shall be the taxable year that results in the least aggregate deferral of income to the partners (as determined under paragraph (a)(2) of this section). See § 1.706-3T(a) for special rules which

provide that certain tax-exempt partners are disregarded.

(2) *Taxable year that results in the least aggregate deferral of income.* The taxable year that results in the least aggregate deferral of income will be the taxable year of one or more of the partners in the partnership which will result in the least aggregate deferral of income to the partners. The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each partner that would be generated by that year and each partner's interest in partnership profits for that year. The partner's taxable year that produces the lowest sum when compared to the other partner's taxable years is the taxable year that results in the least aggregate deferral of income to the partners. If the calculation results in more than one taxable year qualifying as the taxable year with the least aggregate deferral, the partnership may select any one of those taxable years as its taxable year. However, if one of the qualifying taxable years is also the partnership's existing taxable year, the partnership must maintain its existing taxable year. The determination of the taxable year that results in the least aggregate deferral of income shall generally be made as of the beginning of the partnership's current taxable year. The district director, however, may determine that the first day of the current taxable year is not the appropriate testing day and require the use of some other day or period that will more accurately reflect the ownership of the partnership and thereby the actual aggregate deferral to the partners where the partners engage in a transaction that has as its principal purpose the avoidance of the principles of this section. Thus, for example the preceding sentence would apply where there is a transfer of an interest in the partnership that results in a temporary transfer of that interest principally for purposes of qualifying for a specific taxable year under the principles of this section. For purposes of this section, deferral to each partner is measured in terms of months from the end of the partnership's taxable year forward to the end of the partner's taxable year.