

Proposed Regulations Could Require Change in Method of Allocating Taxable Income

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Do your partners have “varying interests” in the partnership during the tax year? If so, new proposed regulations by the Treasury Department could affect the method you use to allocate taxable income. It’s important that you understand these new proposals and how to deal with them if and when they go into effect. Note that these proposed rules won’t likely affect all partnerships, but for those who regularly experience partners entering and leaving a partnership during the year, their impact could be significant.

First, a bit of background: Existing rules provide that each partner in a hedge fund or other pooled investment vehicle must report his or her distributive share of partnership income, deductions, and other items on his or her return for the tax year within—or with which—the partnership’s tax year ends. If a partner’s interest in the partnership changes during that year, each partner’s distributive share of income, gain, loss deduction, or credit for that year gets allocated by any method prescribed by regulations that takes into account the partners’ varying interests. This provision was added to the tax code in 1984, but the Treasury Department is only now proposing regulations to provide methods to account for this “varying interest” rule.

The proposed regulations would apply the varying interest rule in all cases in which a partner’s interest changes during a tax year, regardless of the reason and regardless of what portion he or she disposes of during the year. Most important, the proposed regulations call for the partnership to determine a partner’s share of items using an “interim closing method” that would break the partnership year into separate segments that begin and end with each date on which a varying interest occurs.

Thus, a segment would be created each time a partner makes a withdrawal that reduces his or her interest in a fund. And the fund would separately account for each item of income, deduction, gain, loss, or credit within each segment. So rather than waiting until year-end to account for each partner’s share of taxable items based on their weighted average capital (the method now used by most funds), a fund would need to close its books each time a partner redeemed part or all of his or her interest. The additional record-keeping burden of this provision would be enormous.

That’s the bad news. The good news is that the proposed regulations allow a partnership to use a “proration” method to account for all but “extraordinary items.” This method is very similar to the weighted average capital method

currently used by most funds and wouldn't be nearly as disruptive or complex as the interim closing method. The definition of "extraordinary items" doesn't include many items typically present in a fund setting, so the proration method may provide welcome relief from these otherwise onerous provisions.

Note, however, that according to the regulations, you can use the proration method only "by agreement of the partners." This means you may need to amend your fund's partnership agreement (or LLC operating agreement) in order to use the proration method.

These provisions will become effective upon finalization by the Treasury, but they won't affect taxable years earlier than those beginning after December 31, 2009. Thus, you have time to discuss with your legal counsel the advisability of amending your partnership or LLC agreement to provide for implementation of the proration method. We strongly encourage you to do so. And, of course, we'd be happy to discuss these new rules with you or your legal counsel in more detail.